

**THE USE OF ASSET-BACKED SECURITISATION  
AS A STRATEGIC CONTROL TOOL  
BY EDCON'S  
OntheCards INVESTMENTS**

by

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**Submitted in partial fulfilment of the requirements for the degree of  
MASTERS IN BUSINESS ADMINISTRATION**

**Graduate School of Business  
University of KwaZulu-Natal, Howard Campus**

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**June 2004**

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**CONFIDENTIALITY**

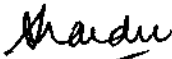
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**RE: Confidentiality Clause**

Due to the strategic importance of this research, it would be appreciated if the contents remain confidential and not be circulated for a period of five years.

Sincerely



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S Naidu

## DECLARATION

I declare that this research report is my own, unaided work. It is being submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the University of KwaZulu-Natal, Howard Campus. It has not been previously accepted for any degree and is not being currently submitted in candidature for any degree.

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## **ACKNOWLEDGEMENTS**

I hereby acknowledge:

1. The patience, love, support and sacrifice of my loving wife, Natasha, who has been a pillar of strength and support during these studies.
2. To my supervisor, Professor Elza Thompson, thank you for the guidance and advice that you have afforded me in completing this research.
3. A special note of appreciation to Mark Bower, Chief Operating Officer of Edcon for his assistance and time in making information available on Edcon and their OntheCards Investments.
4. And last but not least, to my parents who have provided for me so readily during my years of studies.

## **ABSTRACT**

This research report studies the application of Edcon's Asset-Backed Securitisation of OntheCards Investments in the retail industry. Asset-Backed Securitisation is a new concept in South Africa that has been largely practised in the financial sector. The research investigates Edcon's ability to adapt and apply the onerous and rigorous Asset-Backed Securitisation process to achieve their strategic and financial objectives.

As Asset-Backed Securitisation is a new concept in South Africa, which was traditionally applied in the financial sector, the application of this tool in the retail industry would require drastic changes to the business practice of Edcon's credit operations and their strategic evaluation process.

The first part of the research therefore concentrated on the evolution and theory of strategy. This discussion focussed on the evolution of the strategic planning process and eventually concluded with developments in the resource based theory. Strategic frameworks and evaluation techniques were also presented and reviewed.

As part of the literature review, the theory on Asset-Backed Securitisation was also presented and International and South African Perspectives were reviewed with respect to the market for Asset-Backed Securitisation.

Drawing from the literature review on strategy, a strategic evaluation model was developed for the evaluation of Edcon's strategic control tool of OntheCards Investments, their Asset-Backed Securitisation.

The evaluation of OntheCards Investments was focussed on the structure of OntheCards Investments with respect to the theory of Asset-Backed Securitisation, an analysis of Edcon prior to the OntheCards Investments which took the form of a PEST Analysis, SWOT Analysis, Porter's Five Forces Model and a Life Cycle Analysis. The evaluation was concluded by conducting a

situational analysis of Edcon after OntheCards Investments and an assessment of OntheCards Investments with respect to its acceptability and suitability to Edcon's business.

The conclusion drawn from the study was that Edcon had stretch goals and aspirations in OntheCards Investments. Edcon identified the critical success factors for OntheCards Investment and actively achieved the improvement in their credit management operations, which has now yielded an extreme competitive advantage that will not be easily imitated by their competition without major capital investment.

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## **CHAPTER ONE – INTRODUCTION TO STUDY**

### **1.1 Introduction to Chapter**

The literature on strategy and strategic management is extensive. According to Band and Scanlan (1995), the root meaning of 'strategy' is the art of war, and notably, the practice of generalship. Applied to a business setting, the term strategy suggests calculations and decisions by leaders who position their organisation for greatest competitive advantage.

According to Thompson and Strickland (1998:3-20), the strategy making, strategy implementation process consists of five interrelated managerial tasks:

- Forming a strategic vision of what the organisation's future business makeup will be and where the organisation is headed;
- Setting objectives – converting the strategic vision into specific performance outcomes for the company to achieve;
- Crafting a strategy to achieve the desired outcomes;
- Implementing and executing the chosen strategy efficiently and effectively; and
- Evaluating performance and initiating corrective adjustments in vision, long-term direction, objectives, strategy or implementation in light of actual experience, changing conditions, new ideas and new opportunities.

In evaluating the last point above, it is evident that the business environment is dynamic. With this dynamism, strategy evaluation and implementation needs constant evaluation due to externalities. Therefore, a business must have an appropriate plan for implementation of strategy and strategic change.

### **1.2 Background**

The recent economic climate of South Africa has affected the Retail Industry by the fluctuation in the economic climate, which was largely attributable to the turbulence in the interest rate market between the years of 1998 to 2001. Most large organisations with revenues that are healthy would increase their leverage, or

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amount of debt they carry, thereby unlocking tremendous value for the shareholders, both from tax benefits and from the market's well documented perception that managers with less money will spend it wisely (Passov, 2003). However, organisations with high leverage and dwindling revenues are faced with major strategic decisions on maintaining and increasing shareholder value in the face of increasing interest rates and thus higher cost of capital for the organisation. This was the scenario that Edcon encountered during the 1990's.

### **1.3 Value of the Study**

The business environment in which organisations have to formulate, plan and implement their strategy is becoming increasingly complex. The scholarly reviews of academic literature pertaining to corporate strategy are also complex, the challenge is to establish a link or connections between the numerous strategy frameworks, and establish whether an organisation can draw on the best practices from the various strategy frameworks.

Asset-Backed Securitisation is a subject, which is not well understood primarily due to its terminology, which is designed to confuse. By understanding the mechanics of Asset-Backed Securitisation, South African organisations are able to access alternate avenues of financing via efficient use of scarce capital, better management of lending related risks and attracting off-balance sheet transactions enabling higher return on assets.

Another anomaly associated with Asset-Backed Securitisation is that this has been practiced, primarily in the finance sector or banking industry. This association is due to the theory of Asset-Backed Securitisation being steeped in financial knowledge and concepts, which pertains to the structuring aspect of this tool. The value of this study is to determine if this tool can be effectively 'plagiarised' from the banking industry and applied in the retail industry to improve shareholder value for organisations competing in this industry sector.

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## **1.4 Motivation for the Study**

The volatility of the economy presents organisations with many problems pertaining to the operations of their businesses. The harsh business environment is driving management to apply traditional strategic options in a more innovative way, which adds value to their organisations by creating core competence. The study will focus on how Asset-Backed Securitisation can be linked and applied in a strategic way in the retail industry, which is traditionally applied in the banking or finance industry. This is a fairly new application in the retail industry for South Africa, which if successful, could assist retail organisations to focus on their core business practices and develop core competencies by leveraging financial tools and applying them in their respective business environment.

## **1.5 Problem Statement**

To what extent is Edcon able to adapt and apply the onerous and rigorous Asset-Backed Securitisation process to achieve their strategic and financial objectives?

## **1.6 The Objectives of the Research**

- i. To evaluate the strategy decision process within Edcon, focusing on their ability in identifying the best practices from the many formal strategic frameworks and application thereof, of these principles in the management of Edcon's business.
- ii. To evaluate the extent to which Asset-Backed Securitisation has been used as a strategic control tool to facilitate Edcon to concentrate on their core competence.
- iii. To assess whether this strategic control tool has added shareholder value to Edcon, by attaining their financial objectives using Asset-Backed Securitisation.
- iv. To assess whether the credit operations of Edcon is robust enough to enhance and compliment the securitisation of its receivables.

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## **1.7 Research Methodology**

The research findings are presented in the form of a case study, with the analysis presented as a combination of qualitative and quantitative assessment of results. According to Ghauri et al. (1995:85), qualitative and quantitative methods are suitable at different stages or levels of the research. At the first level, the problem is of an unstructured nature and a qualitative method is suitable. The qualitative method typically would be applied to gathering information on the current status of Edcon and their credit operations. At the second level, quantitative methods are most useful, as here one would want to test different hypotheses which we arrived at through level one.

The following formed the basis for the research:

- A literature survey was conducted on strategy and the application of strategic tools;
- A literature survey was conducted on Asset-Backed Securitisation as a strategic tool;
- Data was collected from Edcon, pertaining to their business and their recent Asset-Backed Securitisation (OntheCards Investment);
- An analysis was conducted on Edcon's Asset-Backed Securitisation and strategy process. The nature of the data collection was conducted by means of structured interviews with senior management at Edcon; and
- Recommendations were made with respect to how players in the retail industry, especially Edcon will be able to capitalise on the opportunity presented by Asset-Backed Securitisation.



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## **1.8 The Limitations of the Research**

- Access to confidential records from Edcon, in particular access to intimate knowledge on their strategy making decisions and processes.
- Information and statistics obtained were for a specific time period. Edcon's Asset-Backed Securitisation was completed in July 2002, the benefits might not be completely realised by Edcon, since only two years have elapsed since their OntheCards Investments (Asset-Backed Securitisation).

## **1.9 Contents of the Research Report**

The study was conducted in a systematic approach. The theory on strategy and the various strategic frameworks were discussed. Also included in the literature review was the theory on Asset-Backed Securitisation and the international and South African perspective with regard to the current market for Asset-Backed Securitisation. A strategic evaluation model was developed for Edcon's OntheCards Investments. This strategic evaluation was conducted with respect to the situational analysis of Edcon prior to OntheCards Investments, the situational analysis of Edcon after OntheCards Investments and an assessment of the acceptability and suitability of OntheCards Investment in creating an extreme competitive advantage for Edcon.

**Chapter Two:** The focus in this chapter was in introducing the concept of strategy and corporate strategy and identifying the various strategy frameworks that have been conceived by the many strategy 'Guru's'. Developments in resource based theory are discussed and the concept of strategic control tools associated with resource based theory is explored.

Literature review is also conducted for Asset-Backed Securitisation and identified as a possible strategic control tool for organisations competing in the retail industry. This chapter is concluded with an investigation into the current market of Asset-Backed Securitisation from an International and South African Perspective.

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**Chapter Three:** The focus of this chapter was to identify the strategic options available to Edcon and develop a strategic evaluation model for the evaluation of Edcon's OntheCards Investments.

**Chapter Four:** This chapter focussed on the Evaluation of Edcon's OntheCards Investments. This was accomplished by conducting the following:

- Situational analysis of Edcon prior to OntheCards Investments: This was done using a PEST, SWOT Analysis, Porter's Five Forces Model and AD Little Life Cycle Analysis Portfolio Matrix;
- Situational analysis of Edcon after OntheCards Investments: This was achieved by analysing the current status of Edcon's Operations, a summary of OntheCards Investments, a review of their Credit Operations and the structure of the asset pool that formed OntheCards Investments;
- Assessment of acceptability and suitability of OntheCards Investments: The acceptability and suitability was conducted by ratio analysis of financial statements and determining whether OntheCards Investments were inimitable, durable, appropriate, substitutable and a superior strategy that would contribute to an extreme competitive advantage for Edcon.

**Chapter Five:** This chapter provided a conclusion and recommendations of this research.

## **1.10 Conclusion**

According to Mintzberg et al (1998), discussions pertaining to general management, business policy, corporate strategy, long range planning and corporate management, inevitably focussed on how an organisation in its entirety , can best be directed in a changing world.

The following chapters expand on what has been discussed in this chapter and the best place to start would be to document the evolution of strategy and various strategy frameworks that have been developed through the years, which will be presented in Chapter Two.

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## **CHAPTER TWO – THE ROLE AND FORMULATION OF CORPORATE STRATEGY**

### **2.1 Introduction to Chapter**

This chapter contains the basic philosophy and theoretical departure points on the different views/frameworks on strategy and paradoxes and contradictions related to strategy. The theory on strategy evolution, corporate strategy and competitive strategy is reviewed from previous studies conducted by academics.

The focus of the strategy review concentrates on work conducted by Michael E. Porter (1980) in identifying that the source of industry profitability lies with scanning the external environment. Recent work on resource based theory is revisited, which advocates that sustainable competitive advantage can only be created if an organisation concentrates on developing its internal core competencies, with respect to business processes or developing their people.

The theory on Asset-Backed Securitisation is reviewed, with a view of using this financial instrument as a strategic control tool to assist organisations to focus on their core competence. This chapter is concluded with a review of the Asset-Backed Securitisation market from an International and South African Perspective.

### **2.2 The Evolution of Corporate Strategy**

The environment, which surrounds an organisation changes constantly therefore, the prevailing logic supporting corporate strategy, should be analysed in this context. According to Lynch (2000:47), up until the nineteenth century, organisations, which were not owned by the nation state, were too small to be considered as corporations. Small artisan factories driven by crafts may have needed strategies to survive and prosper against competitors, but formal corporate strategy did not exist. Corporate strategy, which is principally associated with increased industrialisation, was more likely to develop in

Europe, North America and Japan, as these countries were more or less the only areas that had begun to industrialise by the end of the nineteenth century. In the twentieth century (early 1900's) schools of thought on strategy and management began to emerge. F.W. Taylor an American engineer and Henry Gantt designed the scientific management approach. Taylor, the father of 'workstudy' and Gantt, the originator of the Gantt Chart, believed that the most efficient method of doing a task could be scientifically determined which could be used to establish staffing requirements and pay scales (Ungerer et al. 2002:5). Henri Fayol considered the role of management for the first time in 1916. This was known as the administrative management approach to strategy. Many of Fayol's five functions and 14 principles of management are still useful and used (see Table 2.1 – Fayol's Functional Framework):

<b>Fayol's Functional Framework</b>	
<b>Five Functional Areas of Management</b>	<b>14 Principles of Management</b>
1 Plan	1 Division of Work
	2 Authority
	3 Discipline
2 Organise	4 Unity of Command
	5 Unity of Direction
	6 Subordination of individual interest
3 Command	7 Remuneration
	8 Centralisation
4 Co-ordinate	9 Scalar Chain
	10 Order
	11 Equity
5 Control	12 Stability of tenure
	13 Initiative
	14 Esprit de corps

Table 2.1: - Fayol's Functional Framework (Source: Robbins, S.P. De Cenzo, D.A. 1995. Fundamentals of Management. Prentice-Hall International)

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Mayo, Maslow and Macgregor continued with work pertaining to theories on strategy and management, which included the human element. These studies were conducted in the 1930's and into the 1950's. They examined factors that impacted on employee motivation and performance. These studies focused on the insight that people have a huge impact on an organisation's productivity. During this period, the business environment was low in complexity and slow rates of change, which meant that strategic thinking was not essential. The management team could take a decision on their own and 'stake the business' on the decision – the gamblers option of "six or a nix" (Ungerer et al. 2002:6). This period was characteristic of the Second World War, which brought its specialist demands for military equipment coupled with more destruction across much of Europe and Japan; North and South America went largely unscratched. At this time, Middle East and Far East remained outside the scope of industrial development. This period was hardly the time for corporate strategists to influence events (Lynch 2000:50).

The rise of strategy as a common business tool really began in the early 1950's with the work of Newman and later Andrews and Christiansen of the Harvard Business School (Ungerer et al. 2002:6). Since then, the field of strategy has largely been shaped around a framework first conceived by Kenneth R. Andrews in his classic book 'The Concept of Corporate Strategy'. This book identified strategy as the match between what a company can do (organisational strengths and weaknesses) within the universe of what it might do (environmental opportunities and threats) (Collis and Montgomery 1995:121). The work of Andrews did not give managers the insights about how to assess the two aspects of the above framework. Michael E. Porter was credited with the first important break-through in his book 'Competitive Strategy: Techniques for Analysing Industries and Competitors (Free Press, 1980). The focus of Porter's Model is that the structure of an industry determines the state of the competition within that industry and sets the context for an organisation's conduct – that is their strategy.

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Porter (1980) identified 5 structural forces that influenced the average profitability of the industry, which had a correspondingly strong impact on the profitability of the individual corporate strategies. The model advocated three generic strategies (cost leadership, differentiation, and segmentation).

According to Lynch (2002:51) the 1970's saw major oil price rises. They came as a result of the world's increased need for energy and Middle Eastern success in organising an oil price cartel. The business environment was subject to a sudden and largely unpredicted change that caused some corporate strategists to reconsider the value of prediction in corporate strategy or the corporate strategic planning view.

According to Lynch (2002:51), the 1980's and 1990's have witnessed six further environmental developments:

- Increased global competition for many businesses;
- The consolidation and development of trading blocks;
- Information Technology has enhanced cheap and reliable global communication;
- The collapse of Eastern European controlled economies;
- The rise of low wage economies of far eastern countries such as Singapore and Malaysia; and
- Increased levels of training and knowledge of workers.

According to Ungerer et al. (2002:6), the 1980's and 1990's, it became clear that following a strategic recipe (Porter's Model, 1980) did not guarantee success. Resource based theorists argued that the resources and capabilities (or competencies) of an organisation were its only source of competitive advantage. With the appearance of the concepts of core competence and competing on capabilities (Hamel and Prahalad), the pendulum swung dramatically in the other direction, moving from outside to inside the company. These approaches emphasised the importance of both the skills and collective learning embedded in an organisation and of management's ability to marshal them.

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Recently, Peter Senge (1994) cited in Ungerer et al. (2002:9) has identified strategy as a learning process, which has come under the spotlight. This approach pays attention to the organisational learning that happens when people strategise together.

### **2.3 The Definition of Corporate Strategy**

The word 'strategy' means "the art of the general" (from the Greek strategos). Military commanders have an objective – to win the war. To achieve this, the leaders gather intelligence, think about options and alternatives, and decide on a particular course of action and make plans that will eventually lead to a concerted action by others to achieve success (Ungerer et al. 2002:2).

Corporate strategy was defined in 1962 as 'the determination of the basic long-term goals and objectives in an enterprise and the adoption of courses of action and the allocation of resources necessary for carrying out these goals', (Minichiello and Curran cited in McCarthy, 1983).

Corporate Strategy is concerned with an organisation's basic direction for the future: its purpose, its ambitions, its resources and how it interacts with the world in which it operates (Lynch, 2000:5).

These definitions of corporate strategy indicates that corporate strategy is about what we want to do, what we want our organisation to be, or more aptly, how do we grow an organisation to create shareholder value. There seems to be much commonality between the definitions throughout the decades, as evidenced by the above definitions, however corporate strategy is complicated. This complication arises because there is considerable disagreement between researchers on the subject and how its elements are linked together. It is therefore important for an organisation to understand the strategic approach required in the management of an organisation.

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## 2.4 The Strategic Management Approach and the Development of Strategic Planning

According to McCarthy, et al., (1983:14-29) the corporate strategic process or strategic approach consists of three major processes:

- **Formulation of strategy:** This involves the evaluation of the organisations strengths and weaknesses, the identification of the opportunities and threats that the external environment provides and the formulation of the organisation's view of its responsibilities to society;
- **Implementation of strategy:** This involves the structuring of the organisation in order to implement the strategies, which have been formulated, which include setting up of control systems, planning systems and information systems; and
- **Evaluation of strategy:** This involves the review of the results of current strategy in various dimensions, which is inclusive of financial, operational and staff satisfaction.

According to Thompson and Strickland (1998:3-20), the strategy making (formulation of strategy) and strategy implementing (implementation of strategy) consists of five interrelated managerial tasks:

- **Forming a strategic vision of what the organisation's future business makeup will be and where the organisation is headed –** This will provide a long term direction, delineate what kind of enterprise the organisation is trying to become and infuse an organisation with a sense of purposeful action. According to Collins and Porras cited in Thompson et al (1995:3), a well conceived vision consists of two major components: core ideology and envisioned future;
- **Setting objectives –** converting the strategic vision into specific performance outcomes for the company to achieve;
- **Crafting a strategy to achieve the desired outcomes;**
- **Implementing and executing the chosen strategy efficiently and effectively; and**



- 
- Evaluating performance and initiating corrective adjustments in vision, long-term direction, objectives, strategy or implementation in light of actual experience, changing conditions, new ideas and new opportunities.

The above process subscribes to the strategic planning process of assessing the environment and identifying opportunities, identifying a strategy to maximise the opportunity and implementing and monitoring the strategy to take any corrective action within the window of opportunity. According to Mintzberg (1990) strategic planning arrived on the scene in the mid 1960's. Corporate leaders embraced it as the 'one best way' to devise and implement strategies that would enhance the competitiveness of each business unit. The best way involved separating thinking from doing and creating a new function staffed by specialist strategic planners.

The influence of the proponents of strategic planning in the 1970's grew to have an enormous impact on the practice of strategic management (Mintzberg et al 1998). One of these proponents is Michael Porter (1980), whose model details an industry planning process that would lead an organisation to competitive advantage, is discussed below under the definition of competitive strategy.

## **2.5 The Definition of Competitive Strategy**

Porter (1980:26) describes competitive strategy broadly as a plan which defines how an organisation will compete, what its goals should be and what policies are required to carry out the goals and therefore this strategy consists of both the objectives to which an organisation is striving as well as the policies by means of which the objectives are to be met. This model is aligned to the classical theory on strategy and the strategy planning process.

Porter (1980:10) states that competitive strategy examines the way in which an organisation can compete more effectively to strengthen its market position. This competitive strategy must be formulated within the confines of what is socially acceptable competitive behaviour which is established by ethical

standards and through public policy. Porter (1980:23) further states that competitive strategy maybe:

- Implicit – relatively undefined and occurring in an ad hoc manner in each of the functional departments; or
- Explicit – a formulated process that has developed through a planning process.

Porter (1980:27) identified 'The Wheel of Competitive Strategy', which illustrates two distinctive elements of a competitive strategy.

- Mission of the organisation – defines broadly how it is to compete and what its specific objectives are; and
- Operating policies – the vehicle to achieve the mission of the organisation.

Figure 2.1 further highlights the interaction between the objectives and policies of an organisation.



Figure 2.1: - The Wheel of Competitive Strategy (Source: Porter, M.E.1980. Competitive Strategy: Techniques for Analysing Industries and Competitors. New York: Free Press.)

Porter (1980:27-28) identified four key factors that must be considered when formulating a competitive strategy. Figure 2.2 illustrates the context in which competitive strategy is formulated.

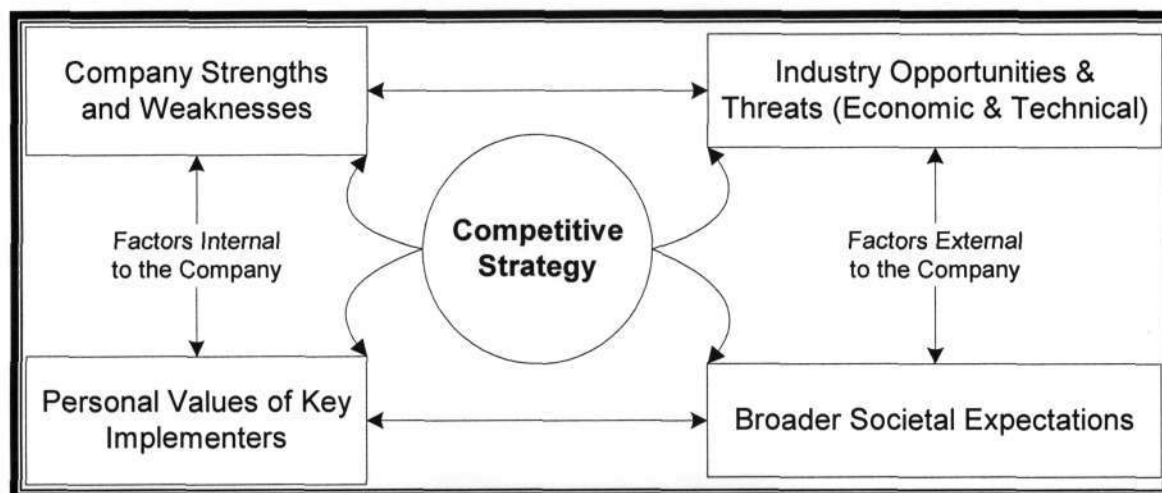


Figure 2.2:- Context within which Corporate Strategy is formulated (Source: Porter, M.E.1980. Competitive Strategy: Techniques for Analysing Industries and Competitors. New York: Free Press.)

The following two aspects determine the internal limits of the competitive strategy of an organisation:

- The organisation's strengths and weaknesses relative to its competitors, in each of the functional departments of that organisation; and
- The personal values of the key implementers of the chosen strategy in the organisation.

The following two aspects determine the external limits to the formulation and implementation of competitive strategy:

- The opportunities and threats to the organisation within its external environment (technology, economy and natural resources); and
- The impact of broader societal influences in the form of governmental regulations, social issues, politics and habits and traditions.

Porter (1983:273-275) identifies strategy as a core in dealing with competition. In his model, Porter (1980) identifies that competition in an industry is determined not only by other organisations in the industry, but also by customers, suppliers, potential entrants and substitute products in competition

with those of the organisation within the industry. Porter's Five Forces Model (1980) as depicted in Figure 2.3 is a powerful tool for systematically diagnosing the chief competitive pressures in an industry and assessing how strong and important each one is.

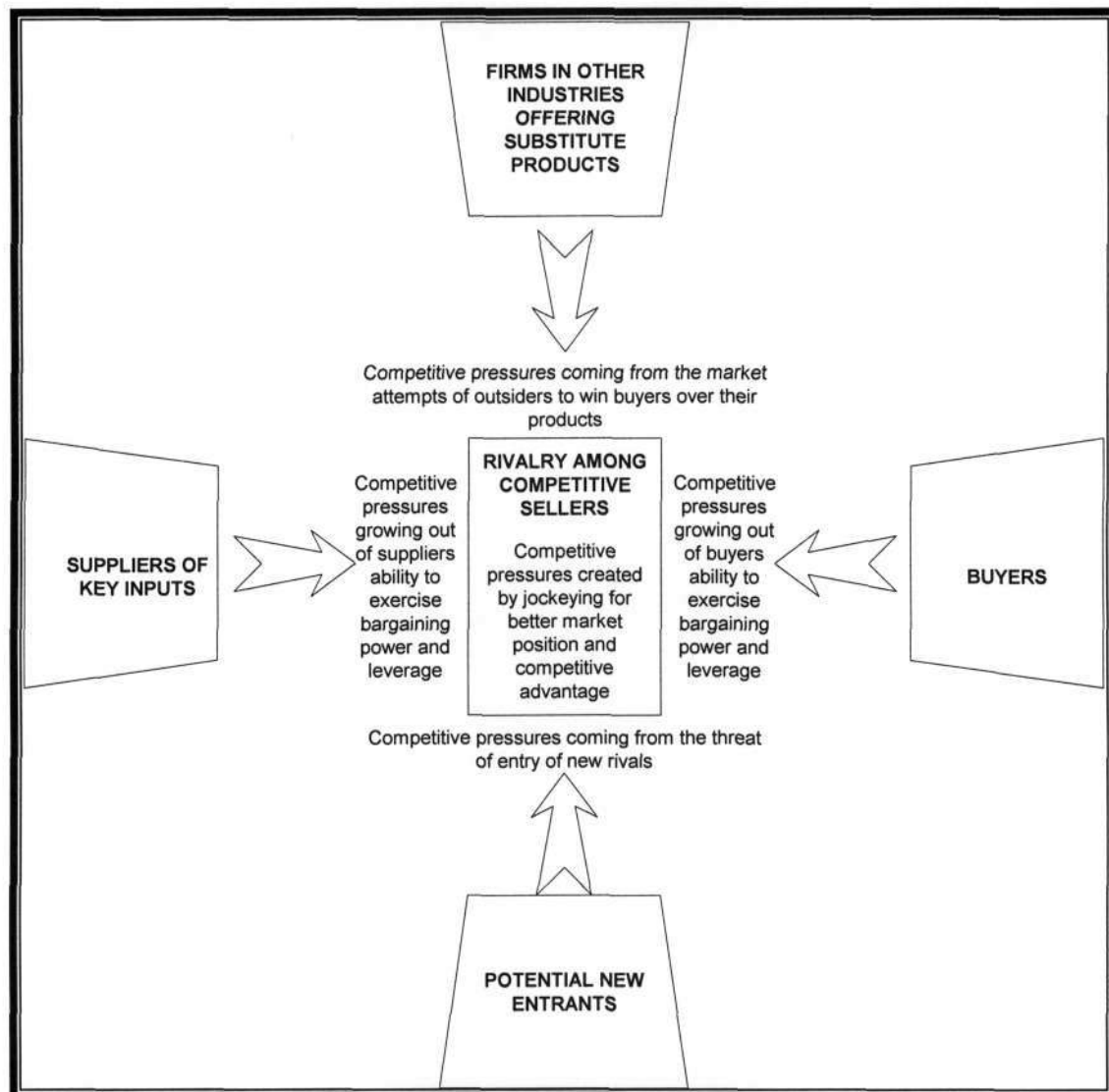


Figure 2.3: - Porter's Five Forces Model (Source: Adapted from M.E. Porter, 'How Competitive Forces Shape Strategy,' Harvard Business Review 57, no. 2 (March-April 1979), pp.137-145, cited in Thompson et. al.

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### **2.5.1 Threat of Potential New Entrants**

When barriers to entry into an industry are low, the threat of new entrants into an industry is high. New entrants to a market bring new production capacity and a desire to secure a place in the market. This secure place is established by exploiting economies of scale, increased capital investment, introduction of differentiated products and little government regulation. The strategic implications of this competitive force are that this threat must be monitored as conditions change and that strategic decisions, which influence a large segment of an industry, can impact strongly on this particular threat.

### **2.5.2 Bargaining Power of Suppliers of Key Inputs**

The dominant market conditions that prevail in an industry, determines how strong or weak this force is in an industry. The impact of this force is minimal whenever items supplied are standard commodities and their availability are in abundance from a large number of suppliers. The opposite is therefore valid in that suppliers exert an influence on an industry if they are few in number, selling unique and differentiated products. Suppliers are generally also more powerful when they can supply a component more cheaply than industry members can make themselves. A strategic decision therefore needs to be made from which suppliers to buy from, to minimise the supplier's influence on the organisation.

### **2.5.3 Bargaining Power of Buyers/Customers**

The power of buyers range from strong to weak and often their buying leverage is a function of industry situations. Buyers leverage is increased if they purchase in large volumes, which entitles them to price concessions and other favourable terms. In this instance, a strategic decision must be made as to the selling to buyers who can exert the least influence on the organisation.

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#### **2.5.4 Threat of Substitute Products or Services**

This threat develops when firms in one industry are in close competition with firms in another industry. Readily available and attractive priced substitutes create a competitive pressure by placing a ceiling on the prices an industry can charge for its product without giving customers an incentive to switch to substitutes and risking sale erosion. The availability of substitutes inevitably invites customers to compare quality, performance and price. Strategically, substitute products must be catered for if they offer a favourable performance to price trade-off and if they are produced by industries earning large profits.

#### **2.5.5 The Rivalry among Competing Sellers**

This is the strongest of all the five forces. The degree of competition between the two competitors in the industry influences an organisation's strategy in that certain strategic moves may reduce the intensity of that competition. The intensity of the competition increases if there are many competitors in an industry or if they are balanced in their respective size and power. The growth opportunities of the industry also has an effect, if the growth is slow, rivalry is high and if the switching costs for customers is low, the rivalry is proportionately higher. Higher exit barriers in the industry also influence rivalry amongst competitors.

According to Porter (1983:285), plans of action can be identified once the five forces in an industry have been analysed. This will yield the organisations strengths and weaknesses.

Porter's Model (1980) thus encapsulates that the crux for developing strategy, is in the understanding of the industry's competitive environment of the organisation. He advocates that competitor analysis is crucial in assessing the strengths and weaknesses of competitors. Clearly, from the above, competitive strategy is integral in corporate strategy and that the analysis of competitors is an essential element of corporate strategy formulation or planning.

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Following, on Porter's Model (1980), leading organisations developed a large staff compliment that reflected the growing confidence in strategic planning. However, the armies of planners that had been assembled and developed have all but disappeared, swept away by the turbulence of the past decade (Collins & Montgomery 1995).

Norton & Irving (1999) argued that the future is too uncertain to predict. Locking an organisation into a plan causes problems when things change. The pace of change no longer allows planning for 15, 10 or even 5 years ahead. The questions we ask; where are we, how did we get here, what business are we in, will we need to change, if so to what; what internal & external factors will have an effect; where do we want to be in the future; need to be asked continually.

Waves of new approaches to strategy were proposed to address these multiple assaults on the premises of strategic planning. After Porter's Model (1980), a new framework has emerged – Resource Based Theory of the firm or organisation.

#### **2.5.6 Resource Based View**

According to Grant (1991:114-115), cited in Ungerer et al. (2002:121), the basic premise of resource based theory is that the roots of competitive advantage are inside the organisation and that adoption of new strategies is often constrained by the current level of the organisations resources. The field of resource based theory consists of a number of related, but distinct branches:

- Resource Based Theory
- Dynamic Capabilities
- Core Competencies Approach
- Embedded Knowledge and Learning

The core capabilities or resources as the basis for competition and differentiation are what a business explicitly knows. It encompasses bundles of skills, unique capabilities, technologies, infrastructure, assets and expertise that

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reside in employees working collaboratively within and across skills sets to create a sustainable competitive advantage. It is this unique combination of intellectual capitals consisting of human, structural and customer capital which creates value for the organisation in the form of financial results. Human capital includes elements of skills, knowledge, attitude, experience and culture. Structural capital includes strategy, systems and procedures, processors and intellectual property in the form of patterns and copyrights. Customer's capital includes brand equity, market share, customer base and information, distribution channels and trade agreements.

### **2.5.7 Criteria for Core Capabilities as a Competitive Advantage**

According to Ungerer et al (2002:122) a core competence is not only an asset, it is an activity set, a messy accumulation of learning. The level of competence must be substantially superior to all others in the industry; it must be unique and must create perceived customer value. Core capabilities are the skills that enable an organisation to deliver a *fundamental customer benefit*. These core capabilities enable an organisation to release multi-application opportunities based on the unique combinations that could be realised. These capabilities are used to drive diversification initiatives.

According to Long & Vickers-Kock cited in Thompson & Strickland (1998:112), all organisations tend to gravitate toward one or another in creation of value (meeting basic requirements at the best price; providing the best product features and quality; and focusing on each customer's needs and providing special services). This in itself will not provide much of a competitive advantage. Instead, each organisation needs to look inward to understand its own specific capabilities and outward to identify its special opportunities in the world around it. Competitive advantage results from the organisation's ability to bring its capabilities and opportunities into balance. The process of identifying the organisation's core capabilities in conjunction with assessing its economic and competitive environment provides an important source of information for profiling the organisation's strategic targets. It is abundantly clear that



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organisations need to focus, but it is important that they focus on those things that add the greatest value.

### **2.5.8 Evaluation of Competitive Valuable Resources**

Resources cannot be evaluated in isolation because their value is determined in the interplay with market forces. A resource that is valuable in a particular industry or at a particular time might fail to have the same value in a different industry or chronological context. According to Collins & Montgomery (1995:120-128), for a resource to qualify as the basis for an effective strategy, it must pass a number of external market tests, to test its value.

#### **2.5.8.1 The Test of Inimitability: Is the Resource hard to copy?**

Inimitability limits competition. If a resource is inimitable, then any profit stream it generates is more likely to be sustainable. Possessing a resource that competitors easily copy; generates only temporary value. Managers fail to apply this test rigorously; they try to base long-term strategies on resources that are imitable. The pinnacle of inimitability is creating a resource that is unique and what economists call path dependency. Simply put, these resources are unique and therefore scarce because of all that has happened along the path taken in their accumulation. As a result, competitors cannot go out and buy these resources instantaneously; instead they must build over time in ways that are difficult to accelerate. Inimitability can also be achieved through economic deterrence, which occurs when an organisation makes sizeable investments in an asset. The competitor could replicate the resource, but because of limited market potential, chooses not to.

#### **2.5.8.2 The Test of Durability: How quickly does this resource depreciate?**

The longer lasting a resource is, the more valuable it will be. Like inimitability, this test asks whether the resource can sustain competitive advantage over time. While some industries are stable for years, managers today recognise that most are so dynamic that the value of resources depreciates quickly. Most resources have a limited life and will earn only temporary profits.

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#### **2.5.8.3 The Test of Appropriability: Who captures the value that the resource creates?**

Not all profits from a resource automatically flow to the organisation that 'owns' the resource. The value is always subject to bargaining among a host of players, including customers, distributors, suppliers and employees. Basing a strategy on resources that are not inextricably bound to the organisation can make profits hard to capture.

#### **2.5.8.4 The Test of Substitutability: Can a unique resource be trumped by a different resource?**

Since Porter (1980) introduced the five forces framework, every strategist has been on the look out for potential substitute product. The resource view pushes this critical question down a level to the resources that underpin an organisation's ability to deliver a good service.

#### **2.5.8.5 The Test of Competitive Superiority: Whose resource is really better?**

The greatest errors that managers make are that they do not evaluate their organisation's resources in relation to their competitors. Core competence has too often become a 'feel good' exercise that no one fails. Every organisation can identify one activity that it does relatively better than other activities and claim that, as its core competence. Unfortunately, core competence should not be an internal assessment of which activity, of all its activities, the organisation performs best. It should be a harsh external assessment of what it does better than competitors, for which the term distinctive competence is more appropriate.

In conclusion, according to Ungerer (2002:127), the concept of core capabilities, lies at the heart of the future sustainable competitive positioning of the business. The resources and capabilities of an organisation are both at the same time the primary constraints and sources of future competitiveness. If the core capabilities of the business (current and future) are consciously known by the leadership team, strategies can be developed to leverage competencies, nurture and protect them and to use them as a base for diversification in business areas that use the same competence base.

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## 2.6 Strategic Control

It is evident that the business environment is dynamic. With this dynamism, strategy evaluation and implementation needs constant evaluation due to externalities. Therefore, a business must have an appropriate plan for implementation of strategic change.

Leading on from the previous discussion surrounding the evolution of strategy, strategic planning and resource based theory, strategic control is a tool identified by Band & Scanlan (1995) for determining the optimum business context for an organisation, by helping focus, lead, shape and anticipate strategic movement.

Strategic control is important because it enables complex organisations to function with the least amount of bureaucracy, formality and centralisation consistent with the imperatives of specialisation, integration, innovation and goal achievement. Strategic control has three approaches:

- **Traditional Approach** – Taking corrective action is the final key intervention, whether in response to external developments or internal performance deviations. In essence, this is a feedback model;
- **Critique Approach** – Schreyogg & Steinmann (1987) proposed a feed forward mechanism, which accounts for features of strategic management such as uncertainty, complexity and the bounded rationality of planning. Thus strategic control is subject to an organisation's strategic goals, assumptions, plans, and revisions to continuous searching critique; and
- **Focused Alignment Approach** – Bungay and Goolld (1991) advocates aligning controls with an organisation's critical success factors to those that are essential for achieving long-term competitive advantage, thereby ensuring that organisations measure and senior managers focus on, truly significant aspects of performance.

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A method of strategic control exercised by Edcon in July 2002 was 'Asset-Backed Securitisation'. Asset-Backed Securitisation is the conversion of assets, which are not marketable into secured debt instruments, which have the potential to achieve marketability and thus generate cash.

Asset-Backed Securitisation is not a new concept but there are different forms of Asset-Backed Securitisations. The most important part of this process is the fact that these financial transactions allocates the risks and rewards to those entities that are best able to accept and therefore able to price them, thus focussing the organisation on their core competence and business objectives.

## **2.7 The Asset-Backed Securitisation Process**

According to the International Finance Corporation (IFC) (2001) Asset-Backed Securitisation is an innovative financing technique with great potential to benefit developing countries in several ways, ranging from increasing the availability of low cost financing for more industry sectors to better distribution of financial and business risks across the market.

Asset-Backed Securitisation is a structured process whereby the segregation of a particular set of cash flows (IFC: 2001) from interests in loans and other receivables are packaged, underwritten and sold in the form of 'Asset Backed' securities (Comptrollers Handbook, 1997:2). By doing so, originators can access funding markets at debt ratings higher than their overall corporate ratings, thereby giving them access to broader funding sources at more favourable rates. This is mobilised by allowing the financing to be based on the risks of the asset pools rather than the originator of the assets.

The process of securitisation creates asset-backed bonds. These are debt instruments that have been created from a package of loan assets on which interest is payable, usually on a floating basis. Techniques employed by investment banks today, enable an entity to create a bond structure from any type of cash flow. Assets that have been securitised include loans such as mortgages, car loans and credit card loans. The loans form assets on a bank

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or finance house balance sheet, which are packaged together and used as backing for an issue of bonds. The interest payments on the original loans form cash flows used to service the new bond issue. Traditionally, mortgage-backed bonds are grouped in their own right, as mortgage-backed securities (MBS) while other securitisation issues are known as asset-backed securities (ABS).

In essence, Asset-Backed Securitisation involves well-established financial principles of diversification, transparency and efficient allocation of risks and rewards to the parties most willing and able to accept them.

## 2.8 Parties to the Securitisation Process

Although the specific details of Asset-Backed Securitisation transactions vary enormously, the typical transaction involves the sale by a corporation (the 'originator') of assets to a 'special purposes vehicle' (SPV), which is a corporation or a trust (Iacobucci & Winter 2001). Securitisation is a structured process and involves many role players. Figure 2.4 shows the typical roles players in the securitisation process.

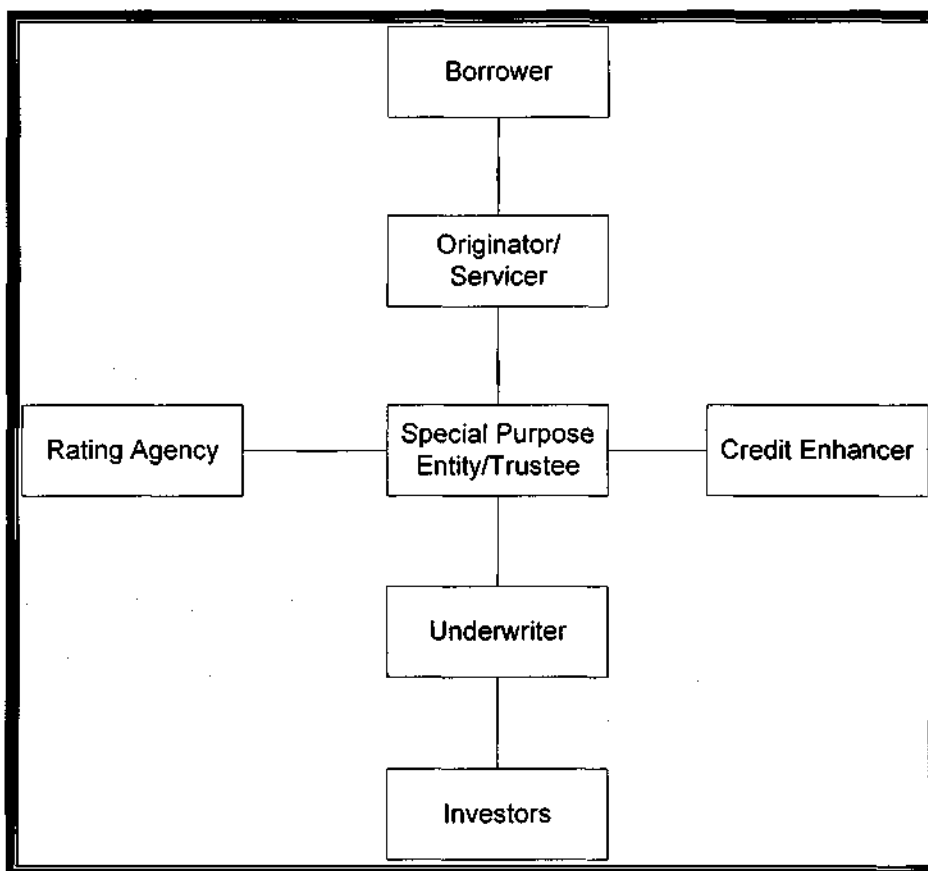


Figure 2.4: Parties involved in structuring Asset-Backed Securitisation (Source: Asset Securitisation, Comptroller's Handbook, November 1997)

### 2.8.1 Borrower

The borrower is responsible for payment on the underlying loans and therefore the ultimate performance of the asset-backed security. Because borrowers often do not realise that their loans have been sold, the originating bank is often able to maintain the customer relationship (Comptroller's Handbook 1997:8).

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### **2.8.2 Origination**

The asset originator transfers the assets to the securitisation entity (Telpner & Traurig 2003:4), which it creates and often services the assets that are sold or used as collateral for asset-backed securities. Originators include captive finance organisations of the major automakers, other finance organisations, commercial banks, computer organisations, airlines, manufacturers, insurance organisations, and securities firms. Commercial banks regularly originate and securitise auto loans, credit card receivables, trade receivables, mortgage loans and other commercial organisations often use securitisation to finance receivables generated from sales of their primary products in the normal course of business (Comptroller's Handbook 1997:9).

### **2.8.3 Servicer**

The originator/lender of a pool of securitised assets usually continues to service the securitised portfolio (Comptroller's Handbook 1997:10). The servicer provides the ongoing administration of the collateral or assets. The servicer or administrator is responsible for the day to day monitoring of the assets, collecting and passing on the cash received, following arrears, foreclosing on bad debts and specifying to the issuer the amount of capital and interest received from the borrowers (Marsden 1990:7). The servicer is typically compensated with a fixed normal servicing fee.

### **2.8.4 Trustees**

For every securitisation, a trustee must be appointed. The trustee is a third party retained for a fee to administer the trust that holds the underlying assets supporting an asset-backed security. The trustee is primarily concerned with preserving the rights of the investor; therefore the trustee must be independent of the issuer, originator and servicer. Generally, the trustee oversees the disbursement of cash flows as prescribed by the indenture or pooling and servicing agreement. Throughout the life of the transaction, the trustee receives periodic financial information from the originator/servicer delineating amounts collected, amounts charged off and collateral values. The trustee is responsible for reviewing this information to ensure that the underlying assets

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produce adequate cash flow to service the securities (Comptroller's Handbook 1997:10). The trustee has the power to dismiss the servicer and appoint another, or take control of the issuer and enforce payment of the instruments by liquidating the collateral (Marsden 1990:9).

### **2.8.5 Credit Enhancer**

Credit enhancement is a method of protecting investors in the event that cash flows from the underlying assets are insufficient to pay the interest and principal due for the security in a timely manner. Credit enhancement is used to improve the credit rating, and therefore the pricing and marketability of the security. Third party credit support is often supported through a letter of credit or security bond from a highly rated bank or insurance company. Internal enhancements such as the senior/subordinated structure can also be used as a credit enhancer in the absence of third party rating agencies. In the internal enhancements, the assets themselves and cash collateral accounts provide the credit support (Comptroller's Handbook 1997:11). The cash collateral accounts and separate, junior classes of securities protect the senior classes by absorbing defaults before the senior position's cash flows are interrupted.

### **2.8.6 Rating Agencies**

Rating agencies may be the single most important players in the securitisation process. Most securitisation will contain multiple tranches, most of which will be rated by one or more rating agencies (Telpner & Traurig 2003:5). These rating agencies evaluate the credit quality of the transactions. The rating agencies review four major areas of the assets:

- Quality of assets being sold;
- Abilities and strength of the originator/servicer of the assets;
- Soundness of the transaction's overall structure; and
- Quality of the credit support.

From this review, rating agencies assess the likelihood that the security will pay interest and principal according to the terms of the trust agreement.



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### **2.8.7 Underwriter**

The asset-backed securities underwriter is responsible for advising the seller on how to structure the security and for pricing and marketing it to investors. Underwriters are often used because of their relationships with institutional investors and for their advice on the terms and pricing requirement by the market (Comptroller's Handbook 1997:12).

### **2.8.8 Investors**

Pension funds, insurance companies, fund managers and to lesser degree commercial banks are major investors of securitised assets. These entities invest in these securitised assets because they provide high rate of return relative to other assets of comparable credit risk.

### **2.8.9 Structuring the Transaction**

Before most loan pools/receivables can be converted into securities, they must be structured to modify the nature of the risks and return to the final investors. Structuring includes the isolation and distribution of credit risk, usually through credit enhancement techniques and the use of trusts and special purpose entities to address tax issues and the management of cash flows (Teasdale, 2003:6).

There are four major stages of the structuring process (Comptroller's Handbook, 1997:13):

- Segregating the assets from the seller/originator;
- Creating a special purpose vehicle (SPV) that hold the assets and protect the various parties interest;
- Adding credit enhancement to improve saleability; and
- Issuing interests in asset pool.

#### **2.8.9.1 Segregating the Assets**

The seller identifies which accounts receivables will be sold to the trust or SPV. This selection is made taking cognisance of the fact that the portfolio performance needs to be predictable. Selection criteria adopted at this phase

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will include past-due receivables that may be left in the eligible pool, but accounts that have a default or write off maybe excluded. Other selection criteria might include data elements such as geographic location, maturity date, and size of the credit line or age of the account relationship. The seller also has the option of random selection of assets or to create selections that are representative of the total portfolio (Comptroller's Handbook 1997:13).

#### **2.8.9.2 Creating Securitisation Vehicles**

Banks usually structure asset-backed securities using grantor trusts, owner trusts, or other revolving asset trusts, each of which issues different types of securities. Trust structures are focused on insulating the assets from the reach of the issuer's creditors and that the issuer, Securitisation Vehicle, and investors receive favourable tax treatment (Comptroller's Handbook 1997:15).

- **Grantor trust:** The certificate holders are treated as beneficial owners of the assets sold. The net income from the trust is taxed on a pass through basis as if the certificate holders directly owned the receivables. The requirement for a grantor trust is that the trust cannot engage in profitable activities for the investors and there cannot be multiple classes of interest. Grantor trusts are used when the underlying assets are instalment loans whose interest and principal payments are reasonably predictable and fit the desired security structure.
- **Owner trust:** The owner trust is similar to the grantor trust, but can issue securities in multiple series with different maturities, interest rates and cash flow priorities.
- **Revolving assets trust:** These may either be stand alone or master trust structures. The stand-alone trust is a simple single group of accounts whose receivables are sold to a trust and used as collateral for a single security although there might be many classes within that security. When the issuer intends to issue another security, it simply designates a new group of accounts and sells their *receivables* to a separate trust.

### 2.8.9.3 Providing Credit Enhancement

Securitisation typically splits the credit risk into several tranches, placing it with parties that are willing or best able to absorb it. The first loss tranche is usually capped at levels approximate to the 'expected' or 'normal' rate of portfolio loss. The credit originator effectively adsorbs all credit losses up to this point, since it typically receives portfolio cash flow after expenses (which include expected loss) in the form of excess spread.

The second tranche typically covers losses that exceed the originator's cap. This second level of exposure is usually capped at some multiple of the pool's expected losses (customarily between three times and five times these losses), depending on the desired credit ratings for the senior positions. This risk is often absorbed by a high grade, well-capitalised credit enhancer that is able to diversify the risk as depicted in Figure 2.5 (Credit Risk Diversification).

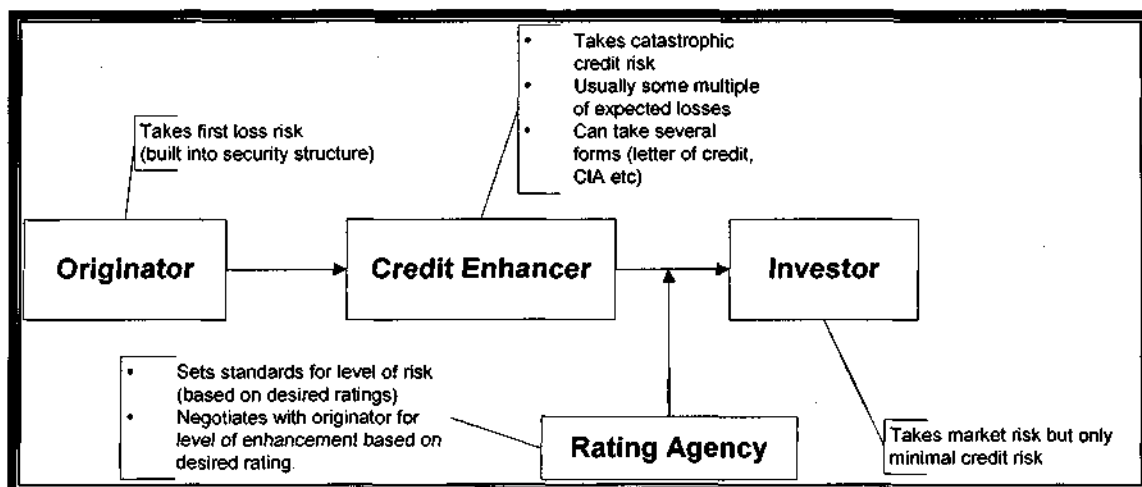


Figure 2.5: Credit Risk Diversification (Source: Comptroller's Handbook, 1997)

The investors that buy the asset-backed securities themselves undertake the third tranche of credit risk. Although investors are exposed to other types of risks, such as prepayment or interest rate risk, senior-level classes of asset-backed securities typically have little exposure to credit loss (Comptroller's Handbook, 1997:20).

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#### **2.8.9.4 External Parties that Provide Credit Enhancements**

The following are external credit enhancement options available in the market (Comptroller's Handbook, 1997:21):

- Third party letter of credit: For issues with credit ratings below the level sought for the security issued, a third party may provide a letter of credit to cover a certain amount of loss or percentage of losses. Draws on the letter of credit protection are often repaid (if possible) from excess cash flows from the securitised portfolio;
- Recourse to seller: Principally used by nonblank issuers, this method uses a limited guarantee of the seller covering a special maximum amount of losses on the pool; and
- Surety bonds: guarantees issued by third parties, usually AAA-rated mono-line insurance companies. Surety bond providers generally guarantee (or wrap) the principal and interest payments of 100% of a transaction.

#### **2.8.9.5 Credit Enhancement Provided by Internal Structure**

According to Comptroller's Handbook (1997:21) structural features can be created to raise the credit quality of an asset-based security. An example of this would be if one or more subordinated security classes and a cash collateral account support a highly rated senior class of securities. Senior/subordinated structures are layered so that each position of benefits from the credit protection of all the positions is subordinated to it. The junior positions are subordinated in the payment of both principal and interest to the senior positions in the securities.

Figure 2.6 depicts a typical security structure containing the following internal enhancements, which is presented in order from junior to senior that is from the first to absorb losses, to the last to absorb losses.

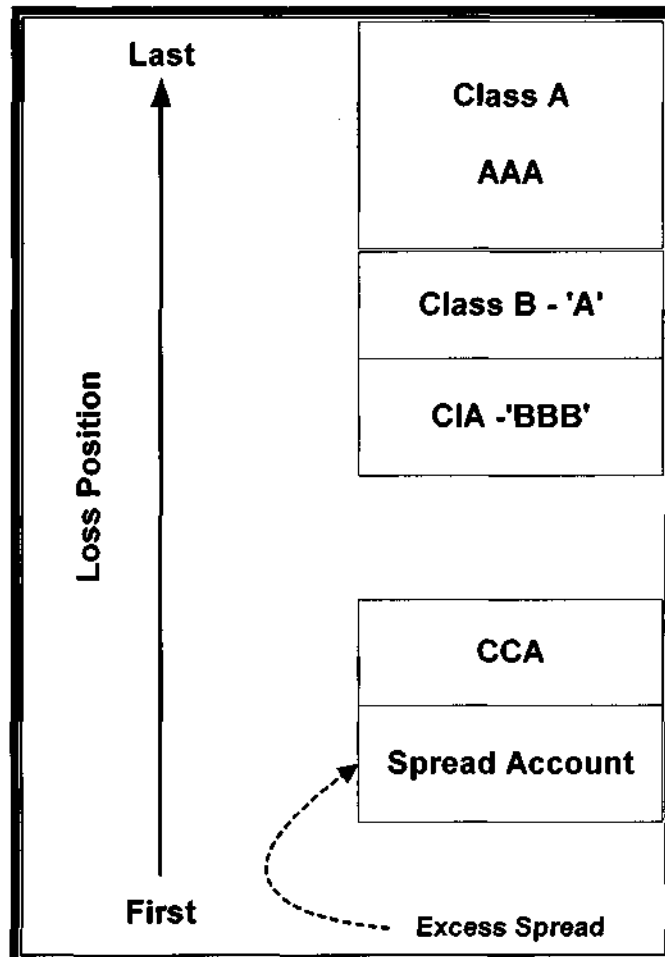


Figure 2.6: Internal Credit Enhancement Structure (Source: Comptroller's Handbook, 1997)

- **Excess spread:** The portfolio yield for a given month on the receivables supporting an asset-backed security is generally greater than the coupon, servicing costs and expected losses for the issued securities. Any remaining finance charges after funding, servicing costs and losses is called 'excess spread.' This residual amount normally reverts to the seller as additional profit. However, it is also commonly available to the trust to cover unexpected losses.
- **Spread account:** Monthly finance charges from the underlying pool of receivables are available to cover unexpected losses in any given month. If not needed, this 'excess spread' generally reverts to the seller. Many

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trusts provide that, if portfolio yields declines or losses increase, the monthly excess spread is captured or trapped in a spread account to provide future credit enhancement.

- **Cash collateral accounts:** A cash collateral account is a segregated trust account, funded at the outset of the deal, that can be drawn on to cover shortfalls in interest, principal, or servicing expenses for a particular series if excess spread is reduced to zero. The account can be funded by the issuer, but is often funded by a loan from a third party bank, which will be repaid only after holders of all classes of certificates of that series have been repaid in full.
- **Collateral invested amount (CIA):** The CIA is an uncertified, privately placed ownership interest in the trust, subordinate in payment rights to all investor certificates. Like a layer of subordination, the CIA serves the same purpose as a cash collateral account: it makes up short falls if excess spread is negative. The CIA is itself often protected by a cash collateral account and available monthly excess spread. If the CIA absorbs losses, it can be reimbursed from future excess spread if available.
- **Subordinate Security Classes:** Subordinate classes are junior in claim to other debt – that is, they are repayable only after other classes of the security with a higher claim have been satisfied. Some securities contain more than one class of subordinate debt and one subordinate class may have a higher claim than other such positions.

Most structures contain a combination of one or more of the enhancement techniques described above. The originator or pool sponsor will often negotiate with the rating agencies about the type and size of the internal and external credit enhancement. The size of the enhancement is dictated by the credit rating desired.

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### 2.8.9.6 Issuing Interests in the Asset Pool

On the closing date of the transaction, the receivables are transferred, directly or indirectly from the seller to the special purposes vehicle (trust). The trust issues certificates representing beneficial interests in the trust, investor certificates and in the case of revolving asset structures a transferor (seller) certificate.

## 2.9 International Perspective in Asset-Backed Securitisation

It is estimated, that the residential mortgage-loan securitisation market in the USA exceeds US\$ 3 trillion per year (Correia, 1999:55). Several other countries in Europe, such as Ireland, and Belgium, are removing the legislative and regulatory impediments to asset securitisation. France and the UK have seen a number of securitised issues of bonds. Emergent speciality credit card banks have driven the growth in the securitisation of credit card receivables, using technology and securitisation to grow their business.

The application of the first securitisation was in 1970, in the USA. Securitisation developed its name and significance out of the debt crisis of the early 1970's in the USA. This process was applied to the residential mortgage market in 1970. The forerunner of the securitisation market in the USA was the Ginny Mae, the best example of a loan-backed security. It was a mortgage-backed security, which is guaranteed by the Government National Mortgage Association (Aber, 1988:5-10).

The success of the mortgage securitisation market, introduced new forms of securitised assets. Securities backed by automobile loans are starting to dominate the asset-backed market place as shown in the following table:

Year	Value of Securitisation
1986	US\$ 10 billion
1987	US\$ 9,9 billion
1988	US\$ 15 million

Table 2.2: Securitisation of Automobile Loans in USA (Source: Hull, E.D. 1989. The Complete Story on Securitisation of Bank Assets: Part 2. The Journal of Commercial Banking. Vol, 69).

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Securities backed by credit card receivables were introduced into the financial market by commercial banks. In April 1986, Bank One in Ohio issued US\$ 250 million in certificates for amortisation of revolving debts. Credit card-backed issues totalled US\$ 7.4 billion in 1987 compared with US\$ 2, 4 billion in 1986. In 1987, the United Kingdom launched its first mortgage-backed issue (Financial Mail 1990:39). By 1989, the sterling mortgage backed securitisation total GBP 6 billion.

Credit Lyonnais launched France's first issuance. This was a US\$ 175 million issue backed by consumer loans (Gentle, 1990:63).

Australia's first issuance was launched in 1985. By the end of 1989, the Australian Dollar mortgage-backed securities market had grown to an aggregate AUD 3.5 billion. Other asset-backed issuances like lease receivables backed transaction was launched at the beginning of 1990.

Other countries to issue mortgage-backed securities are Canada and New Zealand (Lee, 1989:69).

## **2.10 South African Perspective in Asset-Backed Securitisation**

The South African securitisation market is still in its infancy stage. Many players are coming to the fore, from arrangers to trustees. Investors are willing to investigate and consider securitisation paper. Originators are keen to test the water. However, the market is not fully developed in that few issues have been brought to the market and not all issues have been successfully placed (Internet 1).

In November 1989, United Building Society Ltd. conducted the first securitisation. The aim of this securitisation was to obtain experience in the field of securitisation. The securitisation involved an R 250 million pool of mortgages that was listed as an unsecured redeemable mortgage-backed floating rate debenture issue on the Johannesburg Stock Exchange (JSE) in February 1990. The main investors in these MBSs were insurers and pension



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funds and because no secondary market exists for MBSs in South Africa, the MBSs were bought for investment purposes (Faure, 1991:11-17).

Sasfin (Pty) Ltd. conducted the second securitisation in 1991. This issuance included a pool of instalment sale backed assets (machinery, vehicles, rental loans and office equipment). The value of this issuance was two tranches of R 30 million (Business Day, 1990).

Sotta Securitisations International Limited listed on the JSE as a securitisation vehicle in 1998. In 1999, Sotta securitised the rental income from five Lyons Properties. The value of the future rental income was estimated at R 120 million. Lyons conducted the securitisation with the aim to reduce the debt on its balance sheet, increase its equity funds and to shift the tax burden to a special purposes vehicle (Pettendrigh, 1999).

In October 1999, Unibank securitised R 500 million of their term loan books (Mettle, 1999). Saambou Bank packaged R 1 billion of their home loans and sold it to BoE Bank on 31 March 2003. At the end of May 2000, Gensec, JP Morgan and Real Africa Durolink launched the Kiwane Fund. The fund started with an issue of R 500 million.

In July 2002, Edgars Consolidated Stores Limited (Edcon) securitised their store card receivables. The 'Dutch Auction' of the notes to the value of, R 1.93 billion being received by the securitisation vehicle on 29 July 2002 (OntheCards Investment, 2002).

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## **2.11 Limitations and the Regulatory Environment in South Africa**

The process of securitisation is complex and there are regulatory impediments in the South African market. Securitisation requires cash flow modelling and issues such as transfer costs, a thin market and ambiguity in the tax treatment of assets transfers means that there are practical impediments to securitisation.

However, the South African Reserve Bank appears committed to an orderly movement towards removing the impediments that are restricting asset securitisation in South Africa (Correira, 1999).

The South African Reserve Bank states the following in relation to Asset Securitisation:

“The prospect for any emerging country is one of attracting large amounts of capital, which they would otherwise not have been able to attract, from countries such as the United States of America and Japan. South African banks will obviously have to make a commercial decision on whether to become involved in this market. However, there are clear indications that more aggressive institutions in other parts of the world have benefited from positioning themselves as multipurpose players in the real estate capital market.”

The message emanating from the South African Reserve Bank is that they are not opposed to Asset-Backed Securitisation and would like to see an orderly removal of impediments to securitisation.

## **2.12 Conclusion**

The theory on strategy demonstrates the importance of strategy in maintaining the long-term sustainability of a business. The fundamental principles of strategy are the same and need to be applied to the industry a business is competing in.

Chapter Three focuses on the strategy options available and applied by Edcon and presents a Strategic Model on how to assess the strategic decisions made by Edcon.

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## **CHAPTER THREE – STRATEGY EVALUATION MODEL FOR EDGARS CONSOLIDATED STORES LIMITED (EDCON)**

### **3.1 Introduction to the Chapter**

In chapter two, the role and formulation of corporate strategy discussed the strategic options available to organisations or businesses. The challenge is to critically decide on the most appropriate aspects of the various strategic frameworks that were discussed in the previous chapter and identify key strategic options and drivers that are available to Edcon. A strategic evaluation model will be identified on how these strategic choices of Edcon will be assessed in chapter four.

### **3.2 Crafting a Strategy**

According to Thompson & Strickland (1998:42), strategy making is all about how:

- To achieve objectives;
- To pursue business mission and strategic vision;
- To achieve performance targets;
- To out compete competitive rivals; and
- Achieve sustainable competitive advantage.

### **3.3 Types of Strategies available to Edcon**

The following are options available to any organisation regardless of what industry they compete in:

- Unbundling and outsourcing strategies: This strategy can be used when outsourcing pieces of the value chain are performed cheaper by outside specialist and the activity does not remove core competencies or technical know how from the organisation. Its reduces the organisation's risk exposure to changing technology and it streamlines the organisation's operations in a way that improves organisational flexibility, cycle times, speed up decision making and reduce co-ordination costs. In short, it allows an organisation to concentrate on its core business.

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- Co-operative strategies: Alliances and co-operative agreements between organisations can lead to competitive advantage in ways that are otherwise beyond an organisation's reach.
  - Turnaround strategies for businesses in crisis: Turnaround strategies are needed when a business worth rescuing goes into crisis, and the objective is to arrest and reverse the sources of competitive and financial weakness as quickly as possible. This can be done by selling off assets to raise cash to save the remaining part of the business, launching efforts to improve revenues, revising the existing strategy or pursuing cost reduction.

According to Stalk and Lachenauer (April 2004) winners in business play rough and don't apologise for it. They believe that management thinking has gone soft, with its emphasis on 'squishy' things like corporate culture and the coddling of customers. They have in essence reformulated the theory of strategy and view it from a hardball perspective and softball perspective. Their reformulation is not new; it includes the basic theory of strategy discussed thus far, and merely provides a more aggressive outlook on strategy implementation.

Hardball players pursue with a single-minded focus competitive advantage and the benefits it offers; leading market share, great margins, rapid growth, and all the intangibles of being in command. They pick their shots, seek out competitive encounters, set the pace of innovation, and test the edges of the possible. They play to win, and they do. The success of this, hinges on knowledge of the market or the industry. This link can be traced back to Porter's Five Forces Model (1980).

Softball players, by contrast, may look good, they may report decent earnings and even get favourable ink in the business press, but they aren't intensely serious about winning. They don't accept that you sometimes must hurt your rivals, and risk being hurt yourself, to get what you want. Instead of running smart and hard, they seem almost to be standing around and watching. They

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play to play, although they may not end up out-and-out losers, they certainly don't win (Stalk & Lachenauer, 2004:2).

Hardball is not about playing beyond the lines of legality. Hardball players don't cheat. Hardball is not only intense, it's efficient. It cleanses the market. It makes companies strong and vibrant. It results in more affordable products and services, as well as more satisfied customers. It makes competitors sweat. 'Flabby' rivals will sometimes gasp that hardball players are playing too hard, that their advantages are "unfair" or "anticompetitive." Softball players may demand trade restrictions or take their complaints to the press, or to the courts. They will posture and pout. Meanwhile, they will let billions of dollars of shareholder wealth drip into oblivion. This aspect of the strategy alludes to the resource based theory, which advocates attaining competitive advantage via internal resources, which competitors cannot duplicate.

The Hardball Manifesto reiterates the following:

- Focus relentlessly on competitive advantage: Hardball players strive to widen the performance gap between themselves and competitors. They are not satisfied with today's competitive advantage, they want tomorrow's. Many organisations talk about competitive advantage, few are able to identify exactly what theirs is and fewer still can quantify it. Hardball players know empirically, what theirs is and exploit it ruthlessly;
- Strive for extreme competitive advantage: This is unlike competitive advantage which might be fleeting, hardball competitors strive for extreme competitive advantage. This is likely to be achieved if competitors cry that such an advantage is unfair;
- Avoid attacking directly: History shows that for a military to be reasonably assured of success in a direct attack, its strength must be several times greater than its opponent's. Hardball players, even if they have strength, they prefer the economies of force associated with an indirect attack,
- Exploit people's will to win: Hardball requires guts as well as smarts. Victory belongs to those who want it the most. Hardball players therefore have to be action orientated, constantly impatient with the status quo; and

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- Know the caution zone: Hardball involves playing the edges, probing that narrow strip of territory, so rich in possibilities between the places where society clearly says you can play the game of business and those where society clearly says you can't. The hardball player ventures closer to the boundary, whether it is established by law or social conventions, than competitors would ever dare.

Having reviewed the manifesto for the Hardball Strategy, how does one become a hardball player? Stalk & Lachenauer (2004) presents the following five hardball strategies:

- i. Devastate rivals profit sanctuary: Profit sanctuaries are the parts of a business where an organisation makes the most money, where it can quietly accumulate wealth, like a bear storing up fat for winter. If a rival starts pushing into one of your territories, you respond by attacking his plump underbelly. The alternate view could be adopted whereby hardball players develop profit sanctuaries that are internal and thus become an extreme competitive advantage. In Edcon's case, the Asset-Backed Securitisation can be viewed as an internal profit centre as the extreme competitive advantage is developed due the internal links of the business, which are not transparent to competitors.
- ii. Plagiarise with pride: Softball competitors like to think that their bright ideas are sacred. Hardball players are willing to borrow ideas from different markets and transplant them into another market. This is evident in Edcon, as they have plagiarised a tool from the financial sector and applied it to their retail industry.
- iii. Deceive the competition: Hardball players mislead rivals and buy time, to gain any kind of competitive advantage.
- iv. Unleash massive and overwhelming force: Massive and overwhelming force must be the equivalent of a hammer blow: focused, direct, and swift. Consequently, an organisation must be sure it is ready to employ it. An organisation choosing massive force must be ready to completely overhaul its business. The organisation may not face the immediate competitive pressure that typically forces this kind of massive revamping;

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the process can have the feel of a turnaround of a successful organisation.

- v. Raise competitors' costs: Successfully driving up competitors costs without him knowing is one of the marks of a true hardball competitor.

According to Stalk & Lachenauer (2004), these five strategies don't constitute a comprehensive hardball strategy playbook; there are others. Indeed, any strategy that provides you with an extreme but legal competitive advantage is a hardball move. But it's important to emphasize that hardball isn't only about the moves you make. It's also about the attitude you bring to them. A hardball playbook won't do you any good if you feel squeamish about using it.

It is evident that from the theory of strategy, there are many options available to Edcon in forging an extreme competitive advantage. The above discussion, on the options available clearly demonstrates that developing core competence and being aggressive and bold have many advantages in that the first mover will be able to raise barriers to entry into the industry.

Another aspect of strategic management is to systematically identify important groups of people or individuals who can exert a significant amount of influence on the organisation and its competitors (Fleisher & Bensoussan, 2003:298). An important stakeholder in an organisation is shareholders. Shareholders are individuals that invest their money in the organisation. For their investment, shareholders expect a return on their investment as a reward for their investment. Management of an organisation are tasked with providing this return by making decisions that will contribute and add to shareholder value. The following chapter attempts to link how attaining an optimal capital structure relates to the strategy decision making process.

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### **3.4 Theoretical Analysis – Optimal Capital Structure**

Given its equity capital base, managers have to decide what the appropriate level of borrowing for an organisation is. To assist this decision it would be useful to know if it is theoretically possible to increase shareholder wealth by changing the gearing (debt-equity ratio) level, that is, if future cash flows generated by the business are assumed to be constant, can managers simply by altering the proportion of debt in the total capital structure increase shareholder value (Arnold, 1998:774)?

The use of debt in the capital structure of an organisation is called financial gearing. This financial gearing increases the financial risk of an organisation and if successful, has a positive impact on the return to shareholders. The aim of an organisation is to earn a return on the assets, which is greater than their cost of debt. When return on assets is lower than an organisation's cost of debt, this is regarded as negative gearing. When the return on the assets constantly decreases, and the cost of debt remains the same, this leads to financial distress in an organisation, resulting in liquidation of the organisation.

Therefore, for any organisation, there exists an optimal capital structure consisting of debt and equity. This optimal capital structure is the debt to equity ratio that the organisation adopts so that the Weighted Average Cost of Capital/Debt (WACC) is at its lowest (Correia, 1993).

### **3.5 Edcon's Strategy Evaluation and Selection Model**

The intention of this chapter is not to describe the many evaluation techniques for strategy, but rather to identify a strategy evaluation model to be adopted to evaluate the strategy making decisions that Edcon have embarked upon in respect of their Asset-Backed Securitisation – OntheCards Investments (OTC). The following Model will form the basis for chapter four of this research.



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### **3.5.1 Situational Analysis of Edcon prior to the Asset-Backed Securitisation**

In order to evaluate the strategies that Edcon have been effecting over the last few years, it is important to revisit the situation that faced Edcon before it embarked on its Asset-Backed Securitisation process.

A situational analysis will be conducted. This will take the form of a PEST Analysis. This is a simple tool which ought to provide Edcon management with a reality checklist of the general environment that Edcon is operating in. This forms the basis in applying Porter's Five Forces Model. The PEST Analysis incorporates political, economic, socio-cultural and technological aspects of the environment.

Following the PEST analysis, a SWOT Analysis will be conducted and Porter's Five Forces Model on Edcon will be conducted. Together, these three models will set the scene for the evaluation of Edcon's strategic decision making process with respect to the application of their Asset-Backed Securitisation (OntheCards Investments).

### **3.5.2 Situational Analysis of Edcon after the Asset-Backed Securitisation**

Since the focus of the research is to determine the extent to which Edcon is able to adapt and apply the onerous and rigorous Asset-Backed Securitisation process to achieve their strategic and financial Objectives, the situational analysis of Edcon after the Asset-Backed Securitisation will focus on the following:

- Current status of Edcon's business;
- People management strategy adopted by Edcon;
- A summary of their Asset-Backed Securitisation Strategy - OntheCards Investment;
- Review of their current credit operations; and
- Structure of the asset pool that forms OntheCards Investments.

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### **3.5.3 Assessment of the Suitability of OntheCards Investment**

According to Johnson and Scholes (1999:355), suitability concerns whether a strategy addresses the circumstances within which the organisation is operating. In context of this discussion, suitability will be viewed as to whether the Asset-Backed Securitisation added value to Edcon by improving its core competence and assisted Edcon in achieving extreme competitive advantage.

The suitability criteria will be analysed using the following criteria:

- Life Cycle Analysis of Edcon – This will determine whether Asset-Securitisation is an appropriate strategy, given the current status of the organisation.
- Test of inimitability – Is the resource/strategy hard to copy?
- Test of Durability – How quickly does the resource/strategy depreciate?
- Test of Appropriability – Who captures the value of the resource/strategy?
- Test of substitutability – Can a unique resource/strategy be trumped by a different resource?
- Test of Superiority – Is this resource/strategy better?

### **3.5.4 Assessment of Acceptability Criteria of OntheCards Investments**

Acceptability is concerned with the expected performance outcome of OntheCards Investments. This acceptability criterion is measured in terms of risk or return. Financial ratio and statement analysis will be used to assess the acceptability of OntheCards Investments. The evaluation model for Edcon will finally be concluded by providing a conclusion about how feasible Edcon's OntheCards Investments was. It also reviews if the resource allocation was sufficient and if there are any other issues that were not adequately identified. Figure 3.1 (A Framework for the Evaluation of Edcon's OntheCards Investments) provides a summary of the evaluation model to be used.

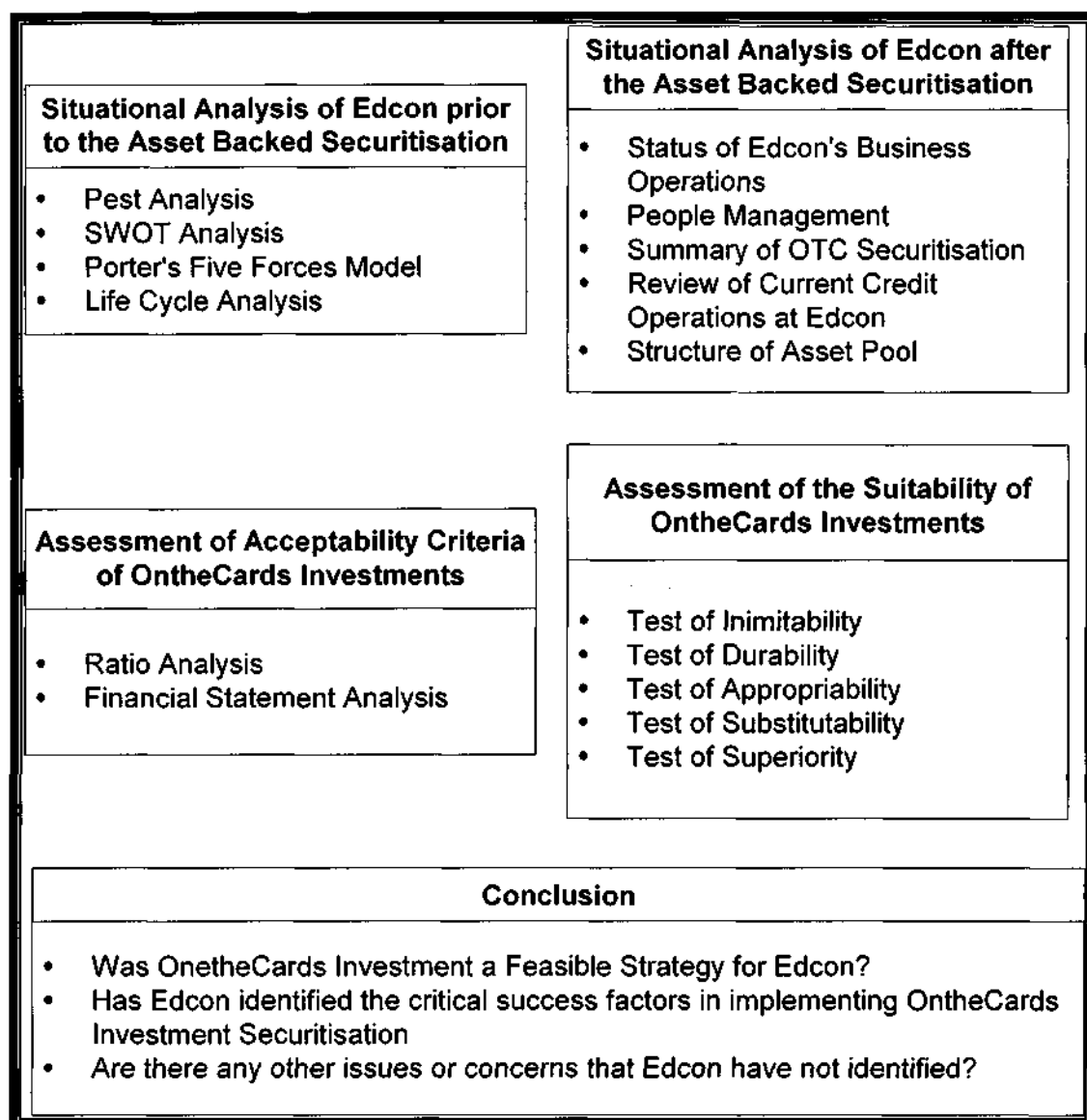


Figure 3.1:- Evaluation Framework for Edcon's OntheCards Investments (Source: - Adapted from - Johnson, G. Scholes, K. Exploring Corporate Strategy. Prentice-Hall).

### 3.6 Conclusion

Having identified the strategic evaluation model for Edcon's OntheCards Investments, this model will be used as the basis for Chapter Four: - Strategic Evaluation of Edgars Consolidated Stores Limited (Edcon). This strategic evaluation model is also summarised and presented in Figure 3.1, The Evaluation Framework for Edcon's OntheCards Investments.

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## **CHAPTER FOUR – STRATEGIC EVALUATION OF EDGARS CONSOLIDATED STORES LIMITED (EDCON)**

### **4.1 Introduction to Chapter**

This chapter provides the analysis of Edcon's Asset-Backed Securitisation of OntheCards Investments. The theory on strategy discusses competitive advantage, but resource based theory takes the debate further by advocating that competitive advantage must be achieved via resources that are easily replicated by competitors. Edcon is acutely aware that the strategies of improving chain stores with respect to fittings, finishes and lower pricing strategy is easily duplicated. Edcon have embarked on an Asset-Backed Securitisation of OntheCards Investments that will clearly separate their credit granting business from their retail operations. This is a strategic tool that they are applying that would yield a strategic and extreme competitive advantage as it would help Edcon by improving their credit operations business. The following chapter provides an analysis of this strategy.

### **4.2 Description of Edgars Consolidated Stores Limited**

Edgars Consolidated Stores Limited (Edcon) is one of the leading retailers in South Africa, with a market share of approximately 20%. Edcon is primarily engaged in the retailing of a range of clothing, footwear, textiles and accessories.

Edcon first traded through the establishment of a single store in Johannesburg in 1929 and was first listed as a public company in 1946. From 1982 until June 1999, Edcon was a subsidiary of The South African Breweries Limited (SAB), which owned 65% of the Company. In 1999, SAB unbundled all but 19.5% of its stake in Edcon ahead of its incorporation of SAB plc and its subsequent listing on the London Stock Exchange (LSE).

#### 4.2.1 Status and Ownership

Edcon is a public company, listed on the Johannesburg Stock Exchange of South Africa (JSE). As of 31 March 2004, the following table illustrates the shareholders with greater than 5% interest in the company:

Shareholders with a holding of greater than 5% of issued ordinary shares	%
Public Investment Commissioner (SA)	8.7
SAB	21.6
United Retail Limited (SA)	10.0
Liberty Life Association of Africa (SA)	7.6
Allan Gray (Holding and Funds)	5.2

Table 4.1:- Edcon's Major Shareholding as at March 2004 (Source: - Edcon's Annual Report 2004)

#### 4.2.2 Group Structure

Edcon operates under its major brand names in the following divisional structure:

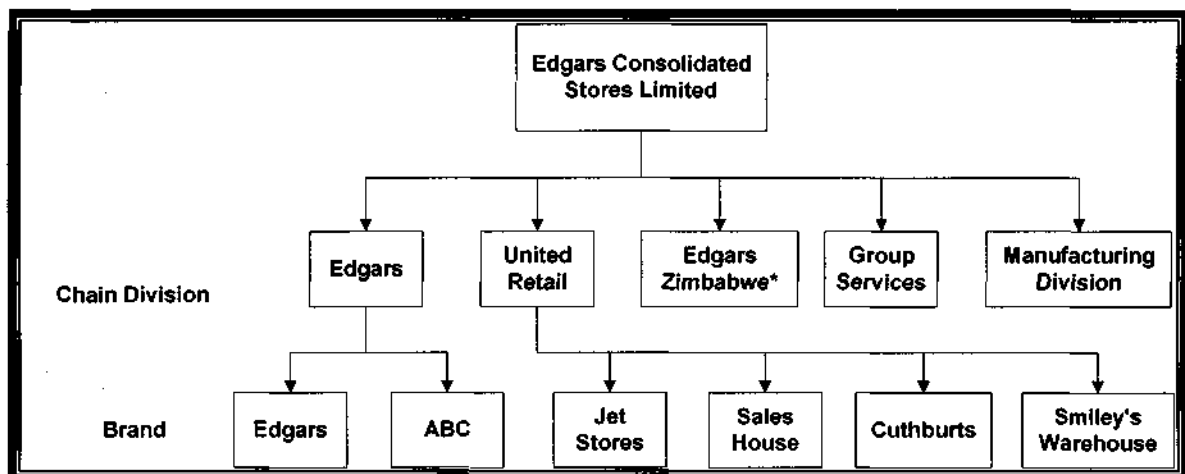


Figure 4.1:- Edcon Group Structure

\* Note that due to political uncertainty and an inability to repatriate dividends from Zimbabwe, Edcon's Board resolved in September 2001 to deconsolidate the results of Edgars Zimbabwe Operations.

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#### **4.2.3 Retail Operating Activities**

- **Edgars:** Edgars is a national chain of department stores that serve middle to upper income families in South Africa. It sells a range of clothing, footwear, textiles, accessories and small home furnishings. The Edgars division also includes ABC stores, which is a shoe retailer serving the same segment of the market.
- **United Retail:** United Retail is a discount chain, targeting the middle to lower income segments of the South African market and includes Sales House, Jet, Smiley's Warehouse and Cuthberts store chains. Sales House and Jet deal in clothing, footwear, textiles and accessories. Smiley's Warehouse specialises in discount ladies wear. Cuthberts is a shoe store targeting primarily the middle-income family.

#### **4.2.4 Other Business Activities**

Edcon provides credit to its customers by way of offering them revolving credit payment plans whereby customers may pay for purchases over a period of time. Credit is made available through StoreCard amounts and the cards work in a similar manner to traditional bank credit cards, however, their use is limited to Edcon Group outlets. These StoreCard can be used at anyone of Edcon's chain stores to make purchases. This allows for the use of any particular chain StoreCard at any other Edcon chain store.

### **4.3 Situational Analysis of Edcon prior to the Asset-Backed Securitisation**

In the late 1990's, Edcon was in the doldrums. Ineffectual management and an appalling credit policy had caused earnings to slump to record lows. Managers were quick to ascribe ill fortune to forces beyond their control, yet poor decisions had contributed greatly to the organisation's precarious position (Business Day Management Review: March 2004).

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### **4.3.1 PEST Analysis**

There are no simple rules governing an analysis of an organisation. Each analysis needs to be guided by what is relevant for that particular organisation. A useful process to begin the analysis is called a PEST Analysis, which focuses on the political, economic, socio-cultural and technological aspects of the environment.

The fashion industry is dynamic and fast changing due to change in fashion trends. Thus, the fashion environment is turbulent to say the least, which makes prediction difficult, as well as making the planning horizon shorter. Edcon therefore, has to be flexible in its response to adapt quickly, while concurrently developing new initiatives.

#### **4.3.1.1 Political**

Currently there are many rules and regulations governing the retail industry. The South African Reserve Bank is playing a part in the retail industry by regulating the repo rate and usury rate. The repo rate relates to the rate that the banks borrow money from the Reserve Bank and lend to their clients. High interest rates stifle demand for retail goods, while lower interest rates create more disposable income to spend on retail goods. The usury rate is the maximum rate as per the Usury Act (1968), that Edcon is able to link its finance charges to debtors, if they do not settle their accounts within the stipulated or agreed time frame.

Since the mid 1990's, South Africa has become a democracy with all South Africans enjoying equal rights. These 'rights' have extended to the corporate realm. Edcon and all other businesses in South Africa are faced with the Black Economic Empowerment Act, which was promulgated in 1998. The key focus of this Act is to provide a more equitable economic distribution in South Africa. Through these measures it would be reasonable to expect a more radical and gender representative workforce, with the emergence of a broader middle class. Management at Edcon has resolved to use Edcon's considerable purchasing power to foster black economic empowerment. Edcon has

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compiled a strategy and policy in conjunction with Labour Unions and all stakeholders. This strategy provides for the identification of black owned enterprises and the setting of targets to ensure that expenditure is diverted to black suppliers.

Too often, the environment is only considered with respect to everything and everyone outside the organisation. The environment also includes 'green' issues and the poisoning of our planet by human activity. At Edcon, they believe they have an obligation to manage the environmental impact of their activities and to ensure at all times that they comply with acceptable safety, health and environmental legislation. The internal auditors monitor compliance on an on going basis and all practices are checked to ensure that they are not polluting the environment.

Another aspect that Edcon has to subscribe to is the code of corporate governance. Corporate governance is concerned with holding the balance between economic goals and between individual and communal goals. The aim is to align as nearly as possible the interests of individuals, corporations and society. At the very heart of corporate governance are the following seven pillars or characteristics which define the attitudes, behaviours and principles which enable an organisation to successfully implement good corporate governance practices. A well governed organisation should clearly possess and display these attributes and characteristics.

- **Fairness:** The decisions and actions of an organisation must be balanced in taking into account the interests of all the stakeholders in that organisation, both from a present and future perspective. Rights of various groups to be acknowledged and respected, e.g. minority shareholder interests must receive equal consideration to those of a dominant shareholder;
- **Accountability:** For all decisions and actions, effective mechanisms must exist to allow shareholders and other stakeholders to query and assess the actions of the organisation, its governing body, its committees, and its management;



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- **Responsibility:** The roles and responsibilities of the governing body, directors, management, and all members or elements of the various structures and processes within the organisation, should be clear and unambiguous;
  - **Transparency:** Ease with which a stakeholder is able to make meaningful analysis of an organisation's actions, achievements, economic fundamentals, and corporate citizenship. Management's ability to make necessary and relevant information available in a candid, accurate and timely manner;
  - **Discipline:** Adherence to universally recognised behaviour, which is accepted to be correct and proper. Encompasses an entity's awareness of and commitment to, the underlying principles of good governance. This is everyone committing to, conforming with and adhering with those "disciplines" which their entity has decided are the appropriate systems, processes and procedures required to achieve its business and service delivery objectives;
  - **Independence:** Every decision and action of the entity, including decisions and actions of those people within the entity, should be objectively and independently made in the interests of the entity itself and its stakeholders. These decisions and actions should not be influenced by any conflicting interests of either the individuals or other related third parties. Mechanisms to avoid potential conflicts of interest, such as governing body composition, governing body committee appointments, external party relationships and internal codes of conduct contribute to independence; and
  - **Social Responsibility:** Awareness of and response to social issues. The entity should be non-discriminatory, non-exploitative, and responsible regarding environment and human rights. Results in indirect economic benefits such as improved productivity, corporate branding and reputation.

In essence, Edcon strives to maintain constructive relationships with government at both national and provincial level. They are committed to complying with all relevant laws and seek constructive engagement with all

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public authorities. Edcon is collaborating with the South African Revenue Services (SARS) to monitor and enforce compliance by their suppliers with the laws governing import duties and value added tax. The vast majority of suppliers conducting business with Edcon have signed an undertaking to comply with current taxation legislation.

#### **4.3.1.2 Economic**

Previously high interest rates and a drop in consumer spending affected the industry. Major retailers such as Foschini, Truworths, and Woolworths with the exception of Edcon, performed relatively well in 1999, relative to poor sales. Consumers are reluctant to incur debt when interest rates are high. These harsh trading conditions are reflected in the Reserve Bank quarterly Bulletin of March 2000. In this report, it states that the credit extended by banks during the first nine months of 1999, remained above inflation as measured by changes in the overall consumer price and core inflation indices. However, the twelve month growth rate in total credit extension fell from 18.5% in December 1998, to 9.9% in the corresponding 1999 period. This slowdown in the demand for credit during this period can be attributed to weaker growth in the demand for credit by private sector bodies.

#### **4.3.1.3 Socio-Cultural**

13.5 million Inhabitants of Africa are estimated to have died from Aids. This represents about 85% of those who have died worldwide. Children and youth, the future labour force, are seen to be the most vulnerable and affected part of the population. HIV/AIDS affects labour productivity as absenteeism via illness of workers and unit labour costs will increase as Edcon pays more for medical aid and group life disability coverage.

Edcon believes that human development and empowerment are integral to sustainability and corporate social investment forms an important part of their strategy. Edcon concentrates on investing in education, social development and to South Africa's dire health challenges. Edcon understands that social development is the cornerstone for building communities that are healthy and strong enough to support our political transformation. Health and educational

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services is highly dependant on the social well being of the people of South Africa and Edcon believe that we cannot truly empower people without necessary interventions in social welfare.

Education is the foundation for a strong society, renewable workforce and a healthy community. Edcon focuses on designing and supporting initiatives to enhance the learning experience for young South Africans.

#### **4.3.1.4 Technology**

Technology is the source of Information. Technology is dynamic and a business like Edcon requires an Information Technology strategy that will improve productivity and efficiency.

#### **4.3.2 SWOT Analysis**

The strengths and weaknesses of Edcon are evaluated with respect to their internal resources, while the opportunities and threats are reflective of the external environment within which Edcon competes.

##### **4.3.2.1 Strengths**

- Edcon has strong market dominance. Edcon is able to identify a variety of customers' needs and thus targeting the different segments in the market place. This has resulted in Edcon becoming a leader in the clothing retail industry;
- Universal presence is another one of Edcon's' strengths. In 1999, the Edcon group operated 703 stores throughout Southern Africa, including 72 stores in Zimbabwe. Edcon had a market share of 27%, which was the highest at the time in the retail clothing and footwear industry;
- Economies of Scale: The Edgars Group was trading under several names until May 1999. The beginning of June 1999 saw the birth of Edgars Consolidated Stores Limited (Edcon), which reflects the activities of the Group more aptly. The consolidation and change of functional style translated into considerable economies of scale. Formerly, each trading department like finance, accounting, credit and development managed its own staff for each of its functions. All of those have now been combined

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and these services will now deliver more value to the chains with lower payroll costs. In general, the brands (Edgars, ABC, and Jet) will be to focus exclusively on merchandise purchasing, promotion and performance. This centralisation has also influenced the Group's general bargaining power as a whole;

- **Leadership and Management Skills:** Edcon is headed by Selwyn MacFarlane. The Chief Executive is Stephen Ross who has been recruited from the United States. Stephen Ross is a New York businessman, with vast retail experience and a fresh perspective from abroad might jolt the organisation into productivity;
- **Product Differentiation:** Edcon is successful in branding the 'issue division' and 'free products' which aims at the young and trendy population;
- **Strong Brands:** Edcon is the only retailer in South Africa with such a large range of national and international brands. In house brands include Kelso, Celio, and Stone Harbour for men, Joe and Baby 123 for kids. International brands include Calvin Klein, Levi's, Nike, Reebok and Adidas;
- **Strong Brand Loyalty:** Edcon has created strong brand loyalty through its in house magazine that is distributed to approximately 1.8 million readers;
- **Supply Chain Channels:** A key strength of the Group is the fact that it owns and controls manufacturing, warehousing and distribution of the majority of its products. The vertical integration of the supply chain is an enormous strength and benefit to any retailer as it can lead to cost savings, consistent product quality and reliability of delivery; and
- **Superior Customer Service:** Edcon has set up help desks, which helps customers to locate merchandise and find out what's being requested most by customers.

#### **4.3.2.2 Weaknesses**

- **Weak finances and cash flows:** Providing credit facilities for both customers and for Edcon was a good idea. However, the '6 months to pay' credit system backfired when the repo rate climbed as a result of the

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Asian crisis. The declining economy had an effect on the customers buying behaviour. Extra cash was being used to pay off debts rather than to purchase new merchandise. This led to Edcon experiencing financial and cash flow problems;

- **Poor record on innovation and ideas:** The use of Naomi Campbell for Sales House advertising campaign was evidently not a profitable idea. Sales House did not show any increase in sales of products after the very expensive campaign. Other recent joint marketing efforts with Edgars Stores have failed as a result of the Group's inefficient operational structure;
- **Structural Instability:** The downsizing and reorganising exercised carried out by Edcon in 1998 and 1999, with a reduction in head count of approximately 1600 and retrenchment costs of R40 million, was most unsettling. These created lower levels of morale in employees, employee insecurity and discontent were noticeable. The loss of strong middle management created instability in the environment; and
- **Information Technology:** Edcon's information technology was not aligned with best practices. Their point of sale inventory management required upgrading and the debtors monitoring software were inadequate.

#### **4.3.2.3 Opportunities**

- **New market segments:** Edcon successfully grasped new trends, such as the move from traditional to western garments. The flux as consumers change their minds over what is trendy brings with it a variety of new opportunities. The opening of South African trading opportunities with its neighbouring states is on the increase with the further development of the South African Development Community (SADC);
- **Population age mix:** In Southern Africa, the younger generation, particularly the young black population, due to better educational opportunities, improved job prospects and affirmative action policies are improving the disposable income available for the more fashion conscious customers. This could be construed as a potential target market; and

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- **Asset-Backed Securitisation:** This is a financial tool if applied could improve debtor's management and its associated business risk, thereby improving the cash flow and finances of Edcon. However, this is a structural process and would require investment by Edcon. The critical success factor for this strategy to be sustainable would be to align their credit operations in line with international best practices.

#### **4.3.2.4 Threats**

- **Change in economic and political environment:** The South African government has encouraged increasingly competitive home markets with lower barriers to international trade. From an export perspective, Edcon is still in the process of expanding internationally, while other competitors like Truworths have already embarked on foreign expansion. The Reserve Bank's policy of weakening of the South African currency means well for core businesses which are export focussed, however in the case of Edcon, many of their clothing brands are imported and thus Edcon would have to pay more as the South African currency is devalued against the US Dollar and the Euro;
- **Strong mergers:** The merging of Truworths and Woolworths in 1981 gave birth to Wooltru, which has embarked on a wave of expansion both locally and internationally. The global network of Truworths places Edcon at a comparative disadvantage where the latter seems to be concentrating energies in an already saturated or mature market;
- **Demographic changes:** Edcon needs to consider socio-cultural effects like HIV/AIDS and how this pandemic will affect its work force; and
- **Technological:** Information Technology has been identified as a weakness within Edcon. Another threat that has appeared is Technology, as Edcon has partnered with Accenture, formerly Anderson Consulting, to outsource its Information Technology. Edcon has come up with an Information Outsourcing strategy which is being adopted by organisations worldwide; which will provide Edcon with a more cost effective service.

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### **4.3.3 Porter's Five Forces Model of the South African Retail Industry**

Edcon is a national departmental store that serves mainly middle and upper class families of South Africa. In terms of numbers, this is certainly a large target segment of the economically active population especially when one considers that there is an ever increasing black middle class emerging since the country became a democracy. With over 700 stores country wide, offering economies of scale, Edcon posted rather poor result since the 1999 financial year, implying strategic changes are radically required. As part of the analysis of Edcon, Porter's Five Forces Model will be briefly reviewed to assess the competitive environmental forces influencing Edcon.

#### **4.3.3.1 Threat of Potential New Entrants**

Domestically, Edcon is a large chain store in the clothing and fashion industry. It owns and operates its own manufacturing division which is complementary yet independent. Their main competitors are also large multi-chain stores with some competitors having an international base. The large economies of scale, already established in the domestic clothing manufacturing and retail industry, make the threat of new rival entrants relatively small.

The immediate concern for Edcon should be to focus strategic initiatives in achieving competitive advantage over existing rivals by improving customer care, total quality management, product innovation and differentiation, distribution and competitive pricing.

#### **4.3.3.2 Bargaining Power of Suppliers of Key Inputs**

Edcon operates in the clothing and fashion and accessories market. Edcon relies for supplies on its own diversified manufacturing division, which supplies predominantly men's and ladies wear, sourcing products from its own factories as well as from overseas suppliers. This division is also seeking export markets. This form of backward integration if optimised can prove highly beneficial in providing efficient and independent product supply chain management.

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The manufacturing divisions are independent business units that allow for quick response replenishment and almost zero dependency on alternative suppliers thereby giving Edcon a comparative advantage in this regard. However, the manufacturing division has shown a loss of R 47 million in 1999.

#### **4.3.3.3 Bargaining Power of Buyers/Customers**

Edcon has strategically targeted different segments of the market. Edcon has achieved this by having Sales House, Edgars Stores, Cuthberts and Smiley's Warehouse covering the different segments of customers. However, this strategy has not proved profitable in recent years. Sales House and Edgars Store, selling exactly the same products posted a loss. The emergence of a rapidly growing black middle class and greater awareness of customers should prompt a re-evaluation of the need to have three brands (Edgars, Sales House and Jet) catering for different income groups and perhaps consider the option of trading under a single banner. Edcon took a beating by failing to meet customer demands and expectations as well as those of competitors. Customers are proving to be more quality, cost, service, fashion and price conscious.

#### **4.3.3.4 Threat of Substitute Products/Services**

The threat of substitutes does not only exist at the product level. Customers often attach equal or greater significance to other aspects of the shopping experience such as store convenience, sales service, staff competence, rest rooms standards, quality, price, security, time lag for new fashions and ideas, and payment method options. These are some of the issues that can act as substitutes for consumers to make a choice of shopping at alternative stores.

Mr. Price, for example sell products at comparatively lower prices (with some compromise in quality) and there is no doubt that there are many price conscious consumers who are willing to sacrifice some quality for a better price. Woolworths emphasises quality. Edcon should do more to promote the quality aspect of its products to attract consumers away from Truworths and Woolworths.



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Rivals easily copy most of the related aspects such as store layout and store convenience. These nevertheless need to continually improve in order to maximise customer migration. A key aspect for Edcon would be to identify and anticipate the customers need, their lifestyles, their reaction to fashion developments and to be able to respond before rival stores in matching merchandise and marketing strategy to consumer needs and preferences.

#### **4.3.3.5 The Rivalry among Competing Sellers**

Edcon's major competitors are Foschini, Woolworths, Truworths, Mr. Price and Pep Stores. These are large multi-chain stores in their own right. Each store positions itself largely on fashion, price, quality, service or any combination of these factors. Edcon needs to continually strive towards improvement and augmentation of its products and services in order to overcome competitive rivalry. Competition also brings with it, improved technology, lower prices, better quality and innovative thinking.

Edcon prides itself as a fashion leader. The financial results for the periods from 1998 to 2001 bear grim testimony to the fact that this is not adequate. As mentioned before, the competitive retailers have capitalised on a combination of quality, price and service. Red Square has been extremely successful for Edcon. Red Square being an upmarket brand in the cosmetics division with superior levels of service and commitment may provide lessons that can be transplanted into other divisions and provide a certain degree of comparative advantage. This still remains a niche market, which has restricted geographical appeal. There is however still scope for expansion within this division.

The nature of the industry lends itself to competitive rivalry and strategies to overcome this rivalry are an ongoing process.

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#### **4.3.4 Life Cycle Analysis of Edcon in 1999**

The PEST Analysis, SWOT Analysis and Porter's Five Forces Model paints an apt picture of what challenges Edcon is facing in the retail industry. It is evident that they possess much strength; as identified in the SWOT Analysis, however their extended outlet stores and brands of Edgars, Sales House, Jet, and Cuthberts are not delivering the shareholder value or cash flows that it ought to have delivered. This is evident by the fact that their March 1999 headline earnings had fallen to a record low of 148 cents per share (Edcon Financial Statements: 1999). Edgars and Jet for example too often targeted the same customer base, creating unnecessary in-house competition and cannibalising overall productivity and profit.

Edcon stable of outlets, Edgars, Sales House, United Retail and Cuthberts, all ran as completely separate entities. Each had its own managing director, human resources and marketing section, property division, information technology department and financial credit division. This implies that Edcon has a portfolio of companies with no overarching strategy. This included the existence of many subcultures which had emerged in the prior years. Another aspect of Edcon's service delivery was that management identified that stores were too large to justify turnover and could easily produce equal profits in smaller spaces.

Given these challenges, management of any organisation and Edcon's management must assess the alternatives that are available to the business. According to Johnson and Scholes (1999:356), the life cycle analysis is an appropriate tool to assess the current status of an organisation. The life cycle/portfolio matrix consists of two dimensions. The market situation is described in four stages ranging from embryonic to ageing and the competitive position in five categories ranging from weak to dominant. The crucial issue is establishing where Edcon is currently positioned on the matrix and therefore use their current position to chart out where they would like to grow and position Edcon in the future. The following Portfolio Matrix has been developed by Arthur D Little, which appears in Table 4.2 below.

		STAGES OF INDUSTRY MATURITY			
COMPETITIVE POSITION		Embryonic	Growth	Mature	Ageing
		Fast Grow	Fast Grow	Defend Position	Defend Position
	Dominant	Start up	Attain Cost leadership	Attain Cost leadership	Focus
			Renew	Renew	Renew
			Defend position	Fast Grow	Grow with industry
	Strong	Start up	Fast Grow	Attain Cost leadership	Find niche
		Differentiate	Catch up	Renew, focus	Hold niche
		Fast Grow	Attain Cost leadership	Differentiate	Hang in
			Differentiate	Grow with industry	Grow with industry
					Harvest
	Favourable	Start up	Differentiate, focus	Harvest, hang in	Retrench
		Differentiate	Catch up	Find niche, hold niche	Turnaround
		Focus	Grow with industry	Renew, turnaround	
		Fast Grow		Differentiate, focus	
				Grow with industry	
	Tenable	Start up	Harvest, catch up	Harvest	Divest
		Grow with industry	Hold niche, hang in	Turnaround	Retrench
		Focus	Find niche	Find niche	
			Turnaround	Retrench	
			Focus		
			Grow with industry		
	Weak	Find niche	Turnaround	Withdraw	Withdraw
		Catch up	Retrench	Divest	
		Grow with industry			

Table 4.2 Life Cycle Portfolio Matrix (Source: - Arthur D Little, cited in Ambrosini, A. 1998. Exploring Techniques of Analysis and Evaluation in Strategic Management. Prentice Hall)

The current analysis of the retail industry is in a mature stage and based on the situational analysis, Edcon is placed in a tenable competitive position as depicted by the position 1 in Table 4.2. The challenge for the management of Edcon is to move Edcon from a tenable position in respect of competitive position to that of strong in a mature stage of the retail industry.

The Life Cycle Portfolio Matrix indicates, for Edcon to move from position 1 to position 2, Edcon would have to embark upon a combination of strategies that is inclusive of turnaround strategies, retrenchment and identifying a niche market or process that would move Edcon from a tenable position to one of a strong position in a mature retail industry. This strong position would be characteristic of Edcon having a competitive advantage by attaining a position of cost leadership and a renewed and focused business.

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Edcon have identified the following as methods of moving to position 2 on the Arthur D Little portfolio matrix:

- Conduct an Asset-Backed Securitisation and improve Shareholder value; and
- Turnaround the Edcon Business by applying an integrated People Management Programme which creates an internal core competence and provide an extreme competitive advantage over their competitors.

The following chapter focuses on the situational analysis of Edcon after the Asset-Backed Securitisation. This situational analysis will focus on Edcon's ability to implement successfully the Asset-Backed Securitisation (OntheCards Investments) by reviewing their credit operations, asset pool identification and people management methodology.

#### **4.4 Situational Analysis of Edcon after the Asset-Backed Securitisation**

According to the CFO of Edcon, Mark Bower, Edcon erred in the 1990's by creating lenient credit collection policies in comparison with standard international practice. Edcon is the biggest grantor of debt in the country, with more active accounts than Visa and MasterCard. The lenient credit collection policies and the granting of debt too liberally over the years produced an unmanageable debtor's book. The strategy that Edcon adopted was to revise their credit granting policies and credit operations by issuing R2.3 billion of debt as an Asset-Backed Securitisation (OntheCards Investments), which yielded R 700 million in cash.

For OntheCards Investments to be a success, the credit operations of Edcon needed to be improved to maintain the sustainability of the Asset-Backed Securitisation. This situational analysis of Edcon after the Asset-Backed Securitisation focuses on the how the credit operations and OntheCards Investments were optimally structured.

#### 4.4.1 Summary of Edcon's Asset-Backed Securitisation (OntheCards Investment)

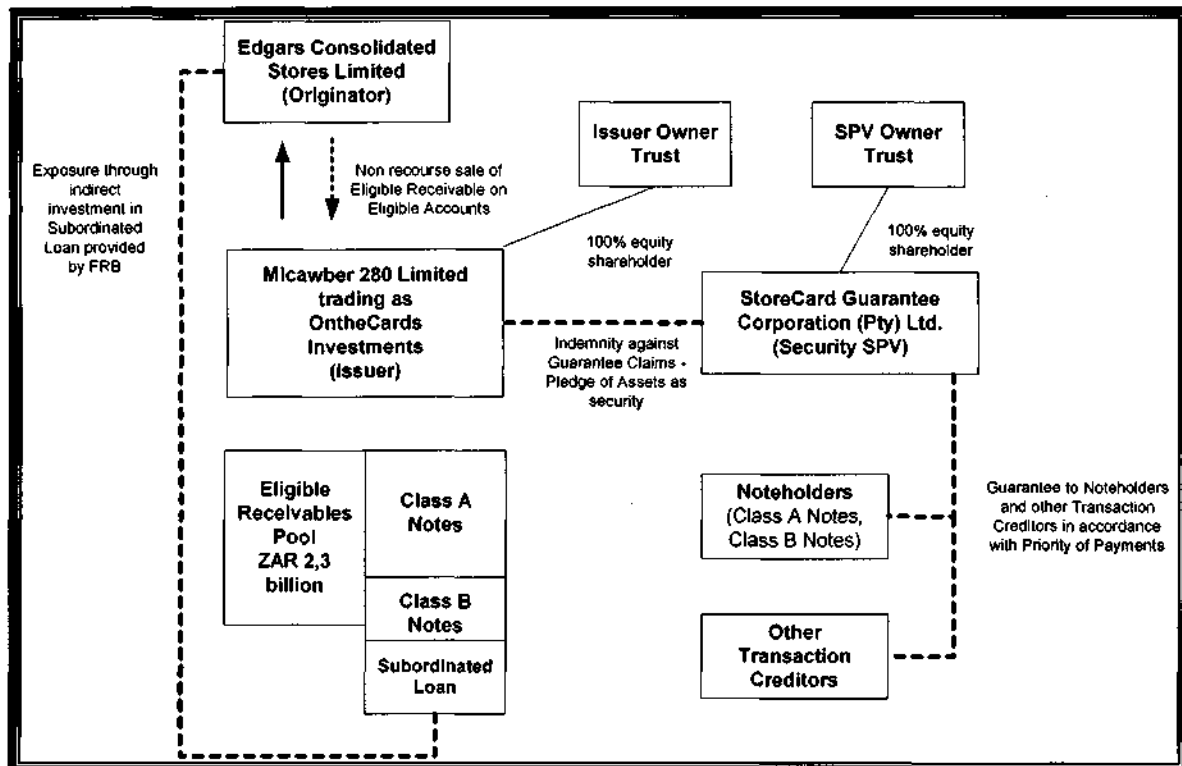


Figure 4.2:- Structure of Edcon's Securitisation (OntheCards Investments) (Source: - OntheCards Investments - Offering Circular, 29 July 2002)

Figure 4.2 reflects a summarised structure of Edcon's Asset-Backed Securitisation (OntheCards Investments). Edgars Consolidated Stores Limited (Edcon) or the originator has sold, free of any encumbrance and on a non-recourse basis, to the issuer all the eligible receivables on certain eligible accounts originated by Edcon, the originator in South Africa. As part of the transaction, only the eligible receivables have been acquired by the issuer. The eligible accounts are retained by Edcon, the originator. The eligible accounts comprise a specific portfolio of accounts meeting the prescribed eligibility criteria as described in the asset pool. At the commencement of the securitisation transaction, the eligible accounts will comprise only the initial eligible accounts, which were opened prior to 22 November 1999.

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Micawber 280 Limited, trading as OntheCards Investments (issuer), in turn, has financed its purchase of the eligible receivables by issuing a series of notes to investors, being:

- ZAR 1,730,000,000 Class A Notes;
- ZAR 200,000,000 Class B Notes; and
- And by obtaining from FirstRand Bank Limited (subordinated lender), a loan in the amount of ZAR 370, 000,000.

OntheCards Investments (issuer) have in turn pledged the eligible receivables which it owns to StoreCard Guarantee Corporation (Proprietary) Limited (Security SPV) as security for the counter-indemnity granted by the issuer to the Security SPV against any claims arising as a result of the Security SPV issuing a guarantee in favour of the noteholders and other transaction creditors of the issuer.

Edcon also performs a servicer role in terms of which it will be obliged to manage the eligible receivables in the ordinary course of its credit management business, as more specifically referred to in the credit procedures manual. Any material changes to the credit procedures manual as regards the eligible receivables will require the prior approval of the Security SPV and a rating affirmation.

Edcon will acquire a first-loss interest in the issuer through an indirect credit linked investment in the ZAR 370,000,000 subordinated loan to be provided to the issuer by the subordinated lender. The subordinated loan is subordinated to the Class B Notes and the Class B Notes and the subordinated loan are subordinated to the Class A Notes. Figure 4.3 shows the internal credit enhancement mechanism adopted by OntheCards Investments.

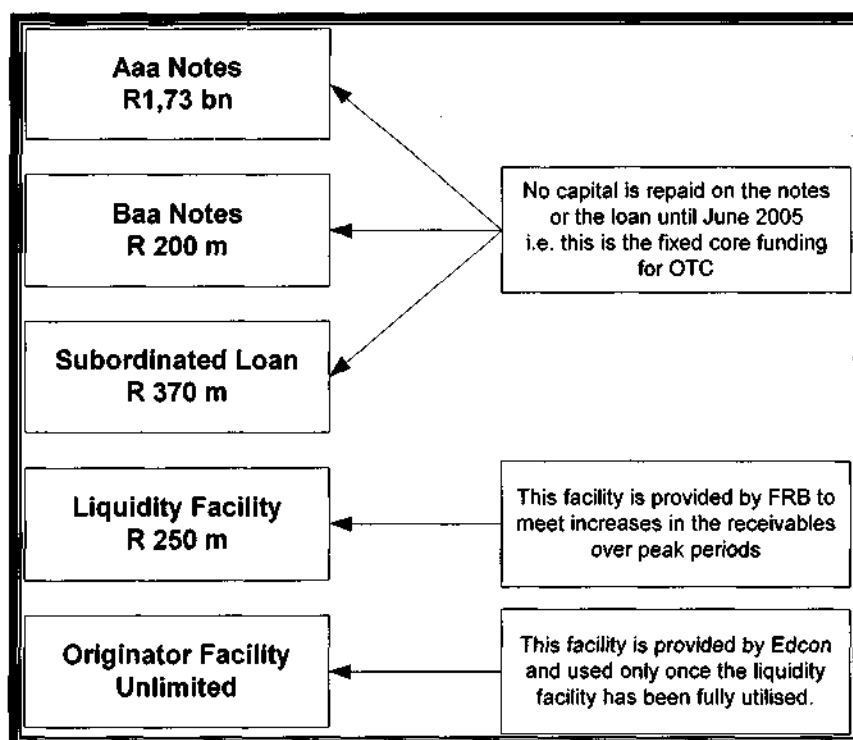


Figure 4.3:- OntheCards Investments Internal Credit Enhancement Mechanism (Source: Asset-Backed Securitisation Conference Proceedings, August 2003)

#### 4.4.2 Ratings Achieved by OntheCards (OTC) Investment

Moody's Investor Services, a leading international rating agency for Asset-Backed Securitisations rated the notes issued by OTC. OTC received the highest possible rating of Aaa on 75% of its funding raised. This percentage is in line with that on international storecard issuances indicating the quality of the underlying receivables.

#### 4.4.3 Ratings Achieved by Edcon

Edcon embarked on obtaining a corporate rating from Moody's, due to the reliance placed on Edcon as originator and servicer of the receivables. A separate Moody's team assessed Edcon's operations and strategic plans. Edcon have become the first corporate in South Africa to have received a Moody's National scale rating of A<sub>3,za</sub>, which is well within the investment grade.

## 4.5 OntheCards (OTC) Asset Pool

The asset pool is made up of the eligible receivables, the bank account and any other permitted investments held by the issuer, Micawber 280 Limited. The eligible receivables comprise of the initial receivables and the ongoing eligible receivables which arise from the eligible accounts.

### 4.5.1 Initial Eligible Receivables of OntheCards Investment

The receivables in the Asset-Backed Securitised portfolio, as at the beginning of the day on 13 June 2002 included R 2,395,230,053. The designated accounts had an average receivable balance of R 1,231 and an average credit limit of R 3,859. The percentage of the aggregate total receivables balance to the aggregate total credit limit was 31.9 per cent. Over 54 per cent of the interest free accounts have been open for a period of more than ten years and 28.3 per cent of interest bearing accounts has been open for at least ten years. 74 per cent of all eligible accounts have been open and in use for a period in excess of five years. As of 13 June 2002, interest bearing accounts represented 52.6 per cent and interest free accounts represented 47.4 per cent of the aggregate eligible receivables balance. Figure 4.4 represents the Geographical Distribution of the Asset-Backed Securitised Portfolio at June 2002.

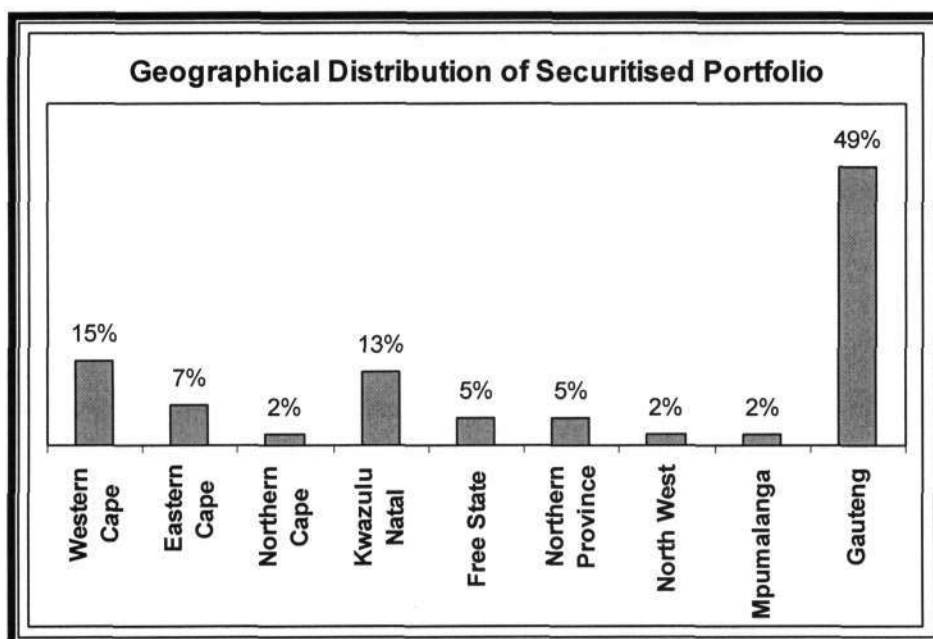


Figure 4.4:- Geographical Distribution of OTC Securitised Portfolio



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## **4.6 Edcon's Credit Operations**

The success of OntheCards Investments hinges on the efficiency of Edcon's credit operations. Therefore this credit operation becomes a critical success factor, and if successful, will yield an extreme competitive advantage for Edcon. The following discussion will review the credit operations that Edcon have embarked on to ensure the success of OntheCards Investments.

### **4.6.1 History of Edcon's Credit Operations**

Edcon have been providing credit to customers for over 60 years and was the first South African retailer to offer the "6 months to pay interest free" credit option in South Africa, a product now being offered by most large clothing retailers.

Prior to 1991, credit granting and management took place at store level. In 1991, the entire credit function was centralised, but managed within each of the Edgars and United Retail Chains, with different credit granting (underwriting) and account management criteria being applied in each. In November 1998, these individual credit divisions were merged into a single group credit division. In February 1999, Edcon introduced specialised credit management software called Vision Plus. At the same time Edcon took a decision to reduce the number of regional credit offices from twelve to three, thereby further centralising the credit management process. Using historical data from the previous 18 months, new application scorecards, developed in conjunction with Fair, Isaac and Company, were introduced in November 1999. Also in 1999, Edcon introduced the use of the Information Trust Corporation and Experian bureau scores in addition to their internally developed scorecards, in a combined application scoring matrix. In April 2000, Edcon introduced TRIAD risk management software for behavioural scoring, credit limit management, authorisations and delinquent collection strategies. Credit strategies are developed in conjunction with PIC Solutions, credit management consultants, and are subject to frequent reviews.

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#### **4.6.2 Credit Management at Edcon**

Edcon currently have a team of five people dedicated exclusively to the centralised credit risk management function. Credit management is supplemented by additional input into risk practices from the operational areas and through the use of external consultants to ensure consistent benchmarking against and therefore compliance with best practices at all times.

Edcon's risk management team has significant experience in the management of consumer credit risk. The group credit division falls under the control of the Group Credit Executive, who reports directly to the Chief Executive Group Services. The Credit Policy Review Committee, which includes representatives from the Credit Risk Management team, the Management Board and the chief executives of the Edgars and United Retail chains, meets monthly to review the status of the debtors' book, credit marketing plans and any changes to credit policy for risk related enhancements. The risk management team all participate in Edcon's share incentive scheme, as well as in the Edcon Group Incentive Scheme, which is based on performance in excess of budgeted requirements, and are therefore provided with incentives to perform in the best interests of the company.

#### **4.6.3 Credit Systems employed by Edcon**

Edcon has invested intensively in information technology over the past few years, focussing on the credit systems required for the optimum management of credit risk. Edcon has a policy of choosing systems that have been scientifically developed and that have proven technologies to improve the quality of the receivables. The credit risk management is extremely reliant on the credit management software, such as Vision Plus Account Management and TRIAD, a risk management overlay to the Vision plus system. Maintenance and development of the Vision Plus system is outsourced to Accenture South Africa and TRIAD is supported by Fair Isaac, for technical support, and PIC Solutions, for strategy consulting purposes.

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The Company's mainframe is outsourced to Comparex Holdings Limited and the software is supported by Accenture South Africa. Edcon has a comprehensive disaster recovery plan in place. There is currently off-site storage of data. A back-up site or an alternative service provider can be made available if necessary. Procedures to be followed in the event of a disaster have been documented in detail.

#### **4.6.4 Credit Options offered by Edcon**

Edcon offers revolving credit to select customers meeting the qualifying criteria under two payment options:

- interest free - the customer charges the equivalent cash cost of the goods acquired to his/her Edcon StoreCard and is entitled to repay the balance on his/her account over a 6 month period without incurring any interest charges thereon. In the event that the customer's account falls into arrears status, the customer will be charged late payment charges on the full outstanding balance; or
- interest bearing - the customer charges the equivalent cash cost of the goods acquired to his/her Edcon StoreCard and is entitled to repay the balance on his/her account over a range of extended periods of 10-20 months, depending on the specific account type. The balance attracts finance charges at the maximum permissible interest rate allowed in terms of the Usury Act, from time to time. There is no credit differentiated pricing of goods.

All sales are made at the same price, whether purchased by cash or on credit. In addition, there is no credit differentiated pricing of credit provided to customers, as customer accounts all attract finance charges at the same rate, being the maximum permissible rate allowed in terms of the Usury Act, regardless of their relative credit risk.

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#### **4.6.5 Credit Procedures Applied by Edcon**

The eligibility criteria in respect of the initial eligible accounts include a requirement that the account was opened prior to 22 November 1999. Subsequent eligible accounts must have been in existence for a weighted average period of at least 12 months. All accounts to be included as eligible accounts therefore have to be seasoned. Account seasoning is a process by which a finite portfolio of accounts matures over time. Non-performing accounts are removed from the portfolio through the charge off process, resulting, over time, in a more stable and better performing pool of accounts.

As the accounts have been seasoned, the performance of those accounts provides a better assessment of the quality of the asset pool than relying on the processes that were in place at the time of the creation of those accounts

#### **4.6.6 Credit Scoring**

Credit scoring is a method of determining the likelihood that customers will meet their account payments. A credit score attempts to summarise the risk profile of borrowers based on their credit history. Fair Isaac, who assisted Edcon in formulating their credit scoring models, is an international firm operating in 60 countries. The firm has developed analytical modelling techniques to assist companies in evaluating credit risk. Approximately 65% of the world's credit cards are managed using Fair Isaac systems. Credit scores are calculated using statistical scoring models and mathematical tables (scorecards) that assign points for different pieces of information which are identified as predictive of future credit performance. Scorecards are developed assuming that the relationships observed between past applicant characteristics and subsequent payment performance will hold true on future applicants. It is therefore necessary that scorecards are reviewed on a periodic basis and re-aligned due to factors such as population shift, changes in macro-economic conditions and so forth.

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Edcon's scorecards evaluate the predictive power for each of 54 characteristics relating to the credit applicant, such as:

- past credit experience;
- stability factors such as time at current job and number of dependents;
- ability to repay based on current income; and
- other volunteered credit references such as bank account details.

Credit scoring is used as part of the application process.

#### **4.6.7 Credit Bureau Scores**

Edcon subscribes to the South African credit bureau databases. Contained in the credit bureau databases is a payment behaviour synopsis for each listed credit user for the preceding 24 months. Applicants for credit will receive different treatment based on their bureau score, as received from either the ITC or Experian credit bureau.

#### **4.6.8 Edcon's Profitability Model**

In order to set the most appropriate cut-off scores for the automatic system-generated accept or decline decision, Edcon utilise a profitability matrix. The matrix is based on an analysis of the profitability of each application, based on all known costs and revenues, for the 12 months following the application acceptance. This approach attempts to maximise the "bottom-line" impact of the application and hence, credit granting process.

#### **4.6.9 Edcon's Granting of Credit**

The credit granting process described below applies to the originator's (Edcon) current credit granting activities. These are continually being revised based on various performance factors, economic trends and in keeping with international best practice.

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Edcon's underwriting is centralised in three regional credit offices (RCO) situated in Johannesburg, Cape Town and Durban. The total staff complement (including permanent and temporary staff) for all three regional credit offices is approximately 1,600 staff members. Pre-conditions to opening an account are that:

- An applicant must not have an existing account with Edcon;
- The applicant must be at least 18 years of age;
- The applicant must either be employed, a pensioner or a student (subject to special conditions); and
- The applicant must produce a valid identity document.

The majority of applications are lodged at store level. In the stores, canvassers may assist customers with form completion and physical ID checking. The completed form is faxed to one of three regional credit offices (RCO) for manual application capture. The regional credit offices receive the faxed form, which is scrutinised for completeness. Incomplete forms are returned to the store, where canvassers will obtain the missing information and re-fax the form back to the RCO if required. Once all relevant information is acquired, the completed form is ready for capturing into the credit decision management (CDM) module of Vision Plus. If a telephonic application is made, applicant information is captured directly into the CDM. Typically this is a store based telephone call, and is termed 'Express Credit'. A small proportion of applications is mailed directly to the regional credit offices or is made via email.

After capturing into the CDM, a new business clerk will process the entire application until a final decision is obtained. During data capture, online validation is used to improve the accuracy of the data input. The system automatically performs the following functions:

- Confirms the minimum age and income criteria are met;
- Confirms that the applicant does not have an existing account with Edcon;
- Performs a bureau check and extracts a bureau score;
- Validates the data on the application form using a data validation system;

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- Runs the application data through the TRIAD application scoring system; and
  - Assigns an automatically generated initial credit limit.

The regional credit office operator will confirm some of the information on the application form telephonically. Edcon has a policy of confirming at least two telephone numbers, where one of the two numbers has to be a landline. Cybertrade, an electronic telephone number provider, is used together with manual calls to confirm employment and home telephone numbers.

#### **4.6.10 Credit Limits Available to Customers**

All successful new account applications will automatically have an initial credit limit assigned to them by the Vision Plus system, after being scored on the profitability matrix. The TRIAD system automatically performs a review of a customer's credit limit every month after an initial 6-month period since the last credit limit increase on the account. The TRIAD system uses the original scorecard and performs further behavioural scoring based on the performance of the account. System-generated increases are limited to a credit limit ceiling of R15 000 per account. Should a special increase be requested by the customer, the credit limit may be increased manually subject to certain criteria being met:

- The account may not be in arrears;
- The last three instalments must have been paid in full;
- The account must have been open and active for at least six months;
- The account must never have been contractually aged by more than three months;
- At least three months must have passed since the customer's last credit limit increase;
- The behavioural score must be over a certain amount; and
- Any manual increase may not cause the new credit limit to be greater than R21 000, without senior credit management approval.

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Where an account is in CD 3 or greater and the customer's behavioural score indicates a high risk, the credit limit is immediately reduced to equal the balance on the account. Where an account is more than 7 billing cycles overdue, the credit limit is reduced to zero. The TRIAD Authorisations system calculates, on a daily basis, whether or not a customer may purchase for more than the Credit available on their statement.

#### **4.6.11 Edcon's Billings and Payment System**

Account statements are run over a period of four days from the 8th to the 11th day of each month. The majority of Edcon customers pay their accounts in store. The customer may also pay via cheque, debit order, postal order, using an automatic teller machine (ATM) or over the internet. Payments are recorded on the Vision Plus system, which updates the customer's account on a real time basis.

#### **4.6.12 Edcon's Accounts Ageing Process**

The ageing process takes place during the billing (statement) run and an ageing calculation is automatically applied to all accounts within the system. In September 2000, a matrix was developed whereby accounts are classified according to two measures:

- The customer's contractual obligation (measured in cycles due or contractual delinquency (CD)) for amounts due in terms of the repayment terms of the account; and
- The recency of the last payment, which is the reference to the time, elapsed since the last qualifying payment for the account was received. A 'Qualifying Payment' means a payment which constitutes at least 75% of the amount due by the customer.

If, for example, an account is categorised as CD 2, it means that the customer has missed one contractual instalment on his/her account. Similarly, if a customer is classified as CD 3, he/she has missed two instalments and so on. Account balances are placed in age categories or buckets within a matrix. Edcon uses this matrix to determine the method of collection required on the



account, if any, and to identify accounts to be written off (charged off). Note that ageing takes place purely on the basis of the contractual delinquency measure as represented by the CD indicator and that the entire account balance and not only the missed instalment portion ages. The recency measure and the matrix indicated below (Table 4.3:- Edcon's Ageing Matrix) is only used in determining whether a particular account should be charged-off (handed over to collection agents). The rationale being that an account holder which is in CD 8, but has made their last two payments is of a different risk profile to an account holder who is also in CD 8, but has missed all eight of their last payments due. In this way, Edcon does not incur unnecessary collection agent costs by handing over account holders which are currently paying.

Only customers in the categories of CD 0, 1 and 2 are permitted to make further purchases. This percentage of the book is classified as 'able-to-buy', as indicated in the matrix below. The able-to-buy percentage is a measure used to express the quality of the book.

		Contractual (Cycle Due 'CD')									
Recency		Prepaid	Current	CD 2	CD 3	CD 4	CD 5	CD 6	CD 7	CD 8	CD 9
		0	1	2	3	4	5	6	7	8	9
	0	C	C								
	1	C	C								
	2										
	3										
	4										
	5										
	6										
	7										
	8										
	9										
C - Current											
C/O - Charged Off											
Able to Buy											

Table 4.3:- Edcon's Ageing Matrix

#### 4.6.13 Edcon's Collection Process

Where an account has been aged into the categories as labelled charged off (C/O) in the matrix above (Table 4.3), the account is charged-off. Edcon manages their collections activity using the TRIAD Delinquent Collection module. Collection priority is determined by a number of factors such as recency, months on books, days since last payment, balance outstanding,

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percentage of limit utilised, behavioural scores etc. These are arranged in a decision tree to determine the required action on the account, such as the timing and intensity of the actions at account level. For example, higher risk and higher balance accounts will receive more urgent attention. Edcon currently collects on all accounts in the CD 2 to CD 7 category regardless of recency. Internal collections are conducted centrally through the company's three regional credit offices. Collections staffs are separated into different operating areas applying different collection approaches and strategies depending on where in the ageing matrix the account is situated.

Predictive diallers (also referred to as power diallers) are currently used in respect of collections activity on CD 2 and CD 3 accounts. In October 2002, the use of predictive diallers was introduced in respect of collections on accounts in the CD 4 to CD 7 categories. The predictive diallers result in far greater productivity amongst collection staff. A staff member using a dialler seat will spend four and a half hours of actual talk time with customers as opposed to a staff member using manual dialling, who will spend only two hours of actual talk time with customers. This results in the collections person using the dialler seat making approximately 200 phone calls per day as opposed to approximately 80 calls by a staff member using manual dialling. The main reason for the performance improvement using power diallers is that the dialler dials the relevant account holder's telephone numbers in a cycle starting during the day (08h00 to 17h00) with the work number, then spouse's work number, then cell number and so forth. After 17h00 during the weekdays and on Saturday mornings, the order of calls is automatically changed to begin with home numbers first. The dialler attempts five calls per number at 15-minute intervals until contact is made with a person. It is only at this point that the dialler software connects the call with a member of the collection staff, at the same time providing on screen information in respect of the customer's details, including account status.

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In-house collections have been enhanced through the introduction of a full team of night collectors in the regional credit offices; this shift operates from 16h00 to 21h00 every weekday. Edcon makes use of advanced software, such as database management systems, predictive dialling systems and tracing systems in the in-house collections area.

#### **4.6.14 Edcon's Charge off and Recoveries Policy**

External collection agents collect all charged-off accounts (as per Table 4.3) and CD 8 and CD 9 accounts prior to charge off (that is, with recency delinquency below 6) on a contingency commission basis. The agents' systems are linked to Edcon's Vision Plus system through daily uploads/downloads of data and the agents' fees are debited directly onto the debtors' accounts, enhancing their cost recovery opportunities. Agents are incentivised to perform due to their collection fees being directly linked to the ZAR value of recoveries made.

In addition, Edcon currently use four collection agents in respect of charged off accounts. Of the four agents the worst performing one will be fired on an annual rotation basis and other agents requested to tender for the vacant position. This acts as further incentive to perform as Edcon, based on number of account holders, is the single biggest provider of retail consumer credit in the South Africa.

#### **4.7 People Management at Edcon**

According to the CEO of Edcon, Steve Ross, Edcon has embarked on a strategy to prioritise people along the lines of Jack Welch of General Electric. This prioritisation of people means that ethics override numbers. According to Ross, Edcon would rather tolerate a person who lives up to a solid value system, than someone who generates money and fails to act in a moral way.

Edcon believes that employee comfort and happiness are the keys to a sustainable turnaround strategy. The human resources function was centralised, which eliminated conflicting management styles and ensured consistency within Edgars, Sales House, United Retail and Cuthberts. By centralising the human resources function, the head office became the epicentre for human resource issues to

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converge. Most turnaround strategies are easily replicated, by other textile retailers. Edcon understood that if change rooms and fancy fixtures, such as larger mirrors are installed; they are easily copied by competitors. Edcon understands that it is easy for competitors to copy clothing styles that sells well, however for competitors to replicate a human resources strategy that is internal, is far more difficult to replicate. It becomes a core competence that provides a competitive advantage which cannot be easily replicated.

A central plank of people management philosophy at Edcon is to regard money as a very powerful incentive tool. Edcon believes companies that hoard all spare cash for shareholders are short sighted. Edcon has a highly individualised bonus system, which Edcon believes is unique and unmatched by any retail company. The usual practice is to increase wage by the same percentage every year, Edcon uses an advanced system. This gives employees the opportunity to actively determine their own increases, which are directly commensurate with performance. One employee may receive an 8% increase, another a 16% increase and another, no increase at all based on the level of output and commitment displayed by the employee. Sometimes, all employees are rewarded. This was the case in May 2003, when management paid 12 500 staff members their regular salary plus an additional sum equal to a third of their monthly salaries. Edcon also uses a mixture of long-term and short-term incentives that is used on an annual basis to pay out a 14<sup>th</sup> and sometimes even a 15<sup>th</sup> cheque, based on levels of performance. At management level, performance is determined by proficient leadership skills and ability to improve profitability. At a lower level, where interface with the public is a primary task, performance is evaluated by quality of service and positive customer feedback. Edcon's long-term incentive is in the form of share options for the staff. Five years ago, all supervisory staff and higher were issued with shares worth R 23. They are now worth R 124 (March 2004). This means that today, each person made a profit of R 101 per share.

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Five years ago, Edcon had an 'ivory tower' mentality. There was a deficit of communication between people, no effective performance management system and a general feeling of disheartenment. Today there is a culture of hope, which recognises and encourages exceptional individuals. People who were once stifled are now recognised and occupy responsible positions.

#### **4.8 Assessment of Acceptability Criteria of OntheCards Investments**

Acceptability of Edcon's OntheCards Investments is concerned with the performance outcomes of the Asset-Backed Securitisation. Edcon's OntheCards Investments was conducted to improve the shareholder value of the organisation and clearly separate the retail and credit business.

##### **4.8.1 Edcon's Risk Factors**

The following general risk factors have been identified for Edcon:

###### **4.8.1.1 Security Risk**

- **Transferability and Size of Holding by Members:** Since Edcon is a public company that has a majority share holding by companies, banks, nominees and finance companies, there are little or no restrictions to the transferability of the shares, therefore there is no impact on the valuation of the shares.
- **Share Marketability:** Edcon shares are traded on the Johannesburg Stock Exchange of South Africa therefore there is no difficulty with its marketability. Since approximately 35% of the shares are traded annually, the share marketability does not have any negative impact on the valuation of Edcon.

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#### **4.8.1.2 Company Risk**

Shareholders are normally interested in all aspects of a business. A shareholder's major concern in investing in an organisation is to establish whether there is an adequate return for the risk taken. In analysing the risk that a prospective investor may be exposed to, the liquidity ratios, asset management ratios and debt management ratios are assessed. These assessments are a fair reflection of the financial state of the organisation and form a tool in assessing the quality of management with respect to the organisation strategy that is being implemented. The ratio analysis has been calculated and is reflected in Table 4.4 – Edcon 7 year review.

The organisation's ability to meet its short-term obligations has remained stable over the period 1998 to 2004. The current ratio has moved from 2.8 in 1998 to 1.7 in 2004. This is partly due to OntheCards Investments as the debtors reflected in 1998 has now been removed and securitised. This decreases the current assets but improves the business risk of Edcon as they have realised the cash earlier rather than later and hence the working capital requirements have decreased. The gearing ratio of Edcon has been identified as 25%. According to the calculated analysis, the gearing ratio has moved from 24% in 1998 to 6% in 2004. This is largely attributable to the R 700 million cash injection that Edcon received when OntheCards Investments was securitised. The financing cost cover ratio is the extent to which Edcon is able to meet its obligations with respect to outstanding debt or financing cost. This ratio has improved since 1998 (7.3) to 2004 (21.3). In view of the above, Edcon's liquidity risk profile is good, which means that their business has cash available and Edcon has access to additional funding from financial institutes as their gearing ratio is 5%, which is well below their target of 25%.

Asset management ratios, demonstrates the ability of Edcon's' assets to generate revenue. Their retail sales growth has increased from 0.4% in 1998 to 26.7% in 2004. Their net asset turn, which is the utilisation of Edcon's assets to generate revenue to substantiate their investment, has improved from 2.1 times in 1998 to 3.5 times in 2004.

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The stock turn of Edcon is a measure of the frequency that Edcon has to replenish their stock. Therefore, the higher the stock turnover rate, the more the revenue. Edcon's stock turn has improved from 3.2 times in 1998 to 5.2 times in 2004, which is 95% of their target stock turn of 5.5 times.

The headline earnings of Edcon have improved from 416 cents per share in 1998 to 1597 cents per share in 2004. This represents a compound growth of 25% over the last six years. The dividends declared by Edcon have also improved quite considerably from 247 cents per share in 1998 to 768 cents per share in 2004. Edcon has targeted a return on shareowners equity of 20%. In 2004, Edcon have achieved this target by registering a 28.3% return on shareowners equity.

The degree of operating leverage is a measure of an organisations sensitivity of its profits to changes in sales. A degree of operating leverage greater than 1 indicates that some operating leverage exists. For example, if the degree of operating leverage is 2, then for every 1% change in sales, profits will change by 2% in the same direction, either up or down (Bodie et al, 1999:518). With Edcon, their degree of operating leverage has moved from 8.7 in 1999 to 4.6 in 2004. The improvement in the degree of operating leverage is good for Edcon's business. In theory, this indicates that Edcon's fixed costs are getting lower, which makes Edcon less sensitive to the degree of operating leverage.

Financial leverage refers to the use of borrowing in an organisation (Bodie et al, 1999: 519). Interest payments on debt must be paid regardless of sales. As discussed, the financing cost cover for Edcon has improved from 7.3 in 1998 to 21.3 in 2004. In line with the above the degree of financial leverage has reduced to 1.1 in 2004.

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The ratio analysis depicts a strong financial position that Edcon finds itself at the end of their 2004 financial year. This can be further emphasised by the fact that Edcon has achieved, if not exceeded the following financial targets:

- Return on shareholders equity has been targeted at 20%, this has been achieved by posting a 28.3% return in 2004;
- Operating profit to retail sales have been targeted at 10%, which has been achieved in 2004 (10.3%);
- Stock turn times has been targeted at 5.5 times, which Edcon has not achieved in 2004 (5.2 times), but the improvement over the years reflects that Edcon is moving towards its targeted goal;
- Financing cost cover has improved from 1999-2001, which was well below its targeted of 5 times and now stands rather healthily at 21.3 times; and
- Gearing ratio, Edcon's targeted gearing ratio is 25% and in 2004, Edcon's gearing is 6%, within the target.

Having analysed the financial statements using ratio analysis, it must be noted that accounting data contain only information that can be expressed in terms of monetary value. Hence any attribute that cannot be expressed in terms of rand value would tend to be ignored. Edcon has an extremely knowledgeable management team and strong employee commitment to superior quality products. The accounting data make no effort to value these human resources. This would not only strengthen the asset base of the company, it would improve the valuation of Edcon.



Year	Six Year Compound Growth % p.a.	2004	2003	2002	2001	2000	1999	1998	Target
<b>Ordinary Share Performance (cents per share)</b>									
Headline earnings basis	25.1	1597.0	786.0	310.4	214.9	411.7	148.4	416.8	
Attributable Cash Flow	88.5	2433.2	2314.4	1123.1	249.9	851.1	489.0	54.3	
Dividends declared for the financial year	20.8	768.0	308.0	117.0	100.0	152.0	58.0	247.0	
<b>Returns (%)</b>									
Return on Ordinary Shareholders Equity	Av 12	28.3	15.7	7.5	5.4	10.7	4.2	12.0	20.0
<b>Productivity</b>									
Net asset turns (times)	Av 2.6	3.5	3.6	2.4	2.1	2.2	2.2	2.1	
Gross profit on retail sales (%)	Av 36.6	39.0	38.6	36.4	35.5	36.2	34.4	36.5	
Cost of selling to retail sales (%)	Av 20.8	18.2	19.2	20.6	20.9	21.8	22.5	22.4	
Retail trading profit to retail sales (%)	Av 6.4	9.0	6.7	5.7	5.4	6.9	3.9	7.4	
Operating profit to retail sales (%)	Av 6.3	10.3	7.3	4.9	3.9	6.7	3.9	7.4	10.0
Revenue - retail sales growth (%)	Av 9.8	26.7	23.9	2.3	2.1	9.8	3.7	0.4	
Stock turn (times)	Av 3.9	5.2	4.7	3.8	3.4	3.7	3.7	3.2	5.5
Effective tax rate (%)	Av 34.3	34.4	39.5	35.5	29.9	30.7	36.4	34.0	
<b>Solvency &amp; Liquidity</b>									
Financing cost cover (times)	Av 8.3	21.3	13.8	5.1	3.0	5.6	1.9	7.3	5.0
Dividend cover (times)	Av 2.3	2.0	2.3	2.6	2.1	2.6	2.6	1.7	
Gearing ratio	Av 0.16	0.06	-0.05	0.16	0.28	0.22	0.24	0.24	0.25
Total liabilities over shareowners funds	Av 0.85	0.92	0.98	0.83	0.84	0.79	0.79	0.79	
Interest free liabilities over total assets	Av 0.33	0.41	0.45	0.31	0.26	0.29	0.28	0.29	
Current ratio	Av 2.1	1.7	1.5	2.2	2.2	2.2	2.2	2.8	
<b>Performance</b>									
Weighted average share price (cents per share)		9672.0	4158.0	2674.0	3539.0	5636.0	3065.0	10296.0	
Price earnings ratio (%)		9.2	6.9	7.8	10.0	17.7	21.0	20.4	
Earnings yield (%)		10.8	14.4	12.8	10.0	5.6	4.7	4.9	
Dividend yield (%)		5.4	6.2	4.9	4.8	2.1	1.8	2.9	
<b>Risk Ratios</b>									
Degree of Operating Leverage (DOL)		4.6	6.6	9.0	11.1	6.6	8.7		
Degree of Financial Leverage (DFL)		1.1	1.1	1.3	1.5	1.3	2.2		
Degree of Combined Leverage		4.9	7.2	11.8	17.1	8.2	18.8		
<b>Other statistical data (at year end)</b>									
Number of full time employees		11,431	12,541	10,766	11,745	14,501	15,255	16,849	
- retailing		10,345	11,269	9,716	10,282	11,725	12,570	14,079	
- manufacturing		1,086	1,272	1,050	1,463	2,776	2,685	2,770	
Number of stores		641	593	449	544	671	703	702	
Gross trading area (000m <sup>2</sup> )		818	775	681	718	788	820	811	
Number of active customer accounts (000)		2,933	2,850	2,860	2,944	3,446	3,725	3,598	

Table 4.4:- Edcon's Seven Year Review (1998-2004) (Source – Edcon Annual Financial Statement – April 2004)

#### 4.9 Assessment of the Suitability of OntheCards Investments

As discussed previously, Edcon are acutely aware that in the retail industry, making cosmetic changes to their chain stores are easily replicated by competitors. This also holds true for discounts offered to clients with regard to minimum purchases. The challenge for Edcon was to initiate a strategy that would provide the following critical success factors of inimitable, durable, appropriate, superior and that cannot be substitutable. The critical success factors for OntheCards Investments will be discussed. These critical success

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factors are Edcon's ability to structure OntheCards Investments according to the theoretical structure for Asset-Backed Securitisation and improving their credit operations that would be critical in maintaining the marketability and credit ratings of OntheCards Investments.

#### **4.9.1 The Test of Inimitability: Is the Resource hard to copy?**

The theory of Asset-Backed Securitisation was presented in chapter two and the structure of Edcon's OntheCards Investments (OTC) was provided in Chapter 4.4.1. It is evident that the OTC was structured according to the theory on Asset-Backed Securitisation. Since the Asset-Backed Securitisation separates the credit risk associated with Edcon, Edcon has revamped their credit operations dramatically as discussed earlier.

The test of inimitability is dependant on making a resource unique and this uniqueness is as a result of path dependency. In Edcon's situation, their revamped credit operations provide a myriad of operations that is interdependent and makes OTC unique and difficult to replicate. Some of the salient aspects of the credit operations include the fact that prior to the OTC, Edcon's credit granting was lenient and non-centralised. In order to apply the OTC successfully, Edcon had to improve the quality of their debtor's book. The measure of the quality of debtors book is the number of customers that are able to purchase. Edcon improved the quality of the debtor's book to 88%, which is well above the international standard. The credit operations were improved by investing in Vision Plus, which is specialised credit management software, implementing new scorecards that are online to the Credit Bureau of South Africa. The development and implementation of all these software and information technology enhancements were based on proven international systems and the implementation was conducted in partnership with leading players in the market, like Accenture South Africa, Fair Isaac, a company that works in 60 different countries. All these implementations enabled Edcon to have a better understanding of the credit risk that Edcon was exposed to and make more informed decisions when new applicants applied to Edcon for a storecard.

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The investment in state of the art information technology and software was critical in structuring the OTC Investments. Critical to the marketability of OTC Investments were the credit ratings of the securities. The OTC Investments received the following Credit Ratings from Moody's, an international credit rating house:

- 75 % of the R 2.3 billion notes received the highest credit rating of Aaa;
- R 200 million of the OTC Investments received a rating of Baa2. Since the OTC Investments of 29 July 2002, the credit rating of the class B notes have been upgraded as a result of bad debt being lower than the expected for this class of debt. The Baa2 rating has been upgraded to A3. The bad debt being lower than expected is largely attributable to the fact that Edcon's credit management was so good it produced income when it was expected to just break even (Business Day, 26 February 2004); and
- Edcon also embarked on obtaining a corporate rating from Moody's, as Edcon would fulfil the role of servicer of the receivables for the OTC Investment. In doing this, Edcon has become the first corporate in South Africa to receive a National scale rating from Moody's of A<sub>3,za</sub>.

Another aspect that has developed the path dependency concept in making the OTC Investment a unique resource for Edcon has been their provision of a subordinated loan of R 370 million. This in essence has improved market sentiment of the OTC Investments as Edcon are willing to absorb initial losses to the value of R 370 million before investors in this Asset-Backed Securitisation are monetarily affected. This demonstrates Edcon's commitment to the process of Asset-Backed Securitisation and their confidence that their business operations are sustainable to produce lasting results that will enhance the Asset-Backed Securitisation and ultimately improve the shareholder value for Edcon.

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The above has demonstrated that the uniqueness of the OTC Investments is a combination of good sound business principles that have allowed the integration of investment in information technology which has improved the credit management of Edcon's business operations. These credit operations are integral to the success of the OntheCards Investments and indications are that it is successful. This resource, OntheCards clearly demonstrates that it is not readily duplicated and would require competitors to assess their business critically and then embark on investments within their businesses to replicate this resource.

The inimitability of OntheCards Investments has been achieved through sustained and bold investments. The decisions made by the management of Edcon in conducting OntheCards Investments have a strong resemblance to a hardball strategy. Edcon have 'plagiarised with pride' in applying Asset-Backed Securitisation' to the retail industry which, has typically been applied in the financial sector by banks. For OntheCards to be successful, 'massive and overwhelming force' was used in reshaping the credit operations of pre 1998 to what it is now in the year 2004. The hardball strategy coupled with implementing key success factors have aided in making the Asset-Backed Securitisation of OntheCards Investments unique and inimitable.

#### **4.9.2 The Test of Durability: How quickly does this resource depreciate?**

The test of durability is concerned how long lasting the resource of OntheCards Investments is. It has only been 2 years since the OTC was marketed, but the structure of OntheCards Investments is sound and there is no reason why it should not be durable if Edcon continue to manage their credit operations as they are doing at present, if not improving upon it.

The durability is further enhanced by the fact that Edcon has announced that they plan to securitise a further R 1 billion of their receivables and use the receipt of this securitisation as an alternative to bank financing for its operations. With Edcon's vision of making further Asset-Backed

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Securitisations, it is evident that OntheCards Investment is a durable resource and would not have a limited lifespan.

#### **4.9.3 The Test of Appropriability: Who captures the value that the resource creates?**

The test of appropriability is concerned with how profits from OntheCards Investments flow to Edcon. The revenue from the OntheCards Investments is spread among investors in the Asset-Backed Securitisation, the SPV and rating agencies. These payments are required as it is the cost of implementing the strategy of Asset-Backed Securitisation. With OntheCards Investments, no revenue flows to the suppliers, distributors or customers and the net profit after payment to the parties of OntheCards Investments flows through to Edcon.

#### **4.9.4 The Test of Substitutability: Can a unique resource be trumped by a different source?**

The only substitutable solution for OntheCards Investments is financing from the commercial banks. This option is available to all competitors, and indeed, this was the source of financing that Edcon adopted prior to OntheCards Investments. OntheCards Investments is regarded as a substitute to the financing option that commercial banks offer.

Currently, Edcon is investigating the option of an American Depository Receipt (ADR) programme through the Bank of New York. The ADR allows companies which are not normally allowed to trade in foreign listed companies to obtain a holding in them. This ADR programme allows Edcon to broaden its investor base in the US and thus attracting more equity. This programme can be construed as a substitute for OntheCards Investments with respect to attracting funding however, for competitors to apply; in short term it is far fetched. Therefore, in terms of substitute offerings available to OntheCards Investments, there is no alternative available at the moment.

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#### **4.9.5 The Test of Superiority: Whose resource is really better?**

Managers frequently make the error of evaluating their resources in relation to their competitors. Unfortunately the superiority of their competence should be an assessment of which activity of all the activities the organisation performs best. The superiority of OntheCards Investments lies with the credit operations of Edcon. The investment in information technology and partnerships with other international consulting houses has not only improved the inimitability of the credit operations, but has ensured that the credit operations and procedures and management is an activity that Edcon performs best, which compliments OntheCards Investments and makes it a superior resource.

#### **4.10 Conclusion**

Investing aggressively in creating competitive advantage is Edcon's most dependable contributor to above average profitability. This is what Edcon have done in order to position OntheCards Investments as an extreme competitive advantage. Good strategy and strategy execution are the trustworthy signs of good management. Competent execution of a well-conceived strategy is not only a proven recipe for success of an organisation but also a good reflection of good leadership. At Edcon, good leadership and management execution of the OntheCards Investments have contributed to the success of OntheCards Investments.

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## **CHAPTER FIVE – CONCLUSION AND RECOMMENDATIONS**

### **5.1 Introduction to Chapter**

According to Porter (1980), organisations are incredibly arrogant to think that it can deliver the same sort of product as its competitors and perform better than them for a long period of time. This statement is more appropriate now than in the 1980's when today technology is improving communication and information transfer. From this viewpoint, recommendations and conclusions will be drawn to this study.

### **5.2 Competition in the Retail Industry**

Competition among existing organisations increases when one or more feel the pressure of competing. Edcon has many competitors, of which Woolworths, Foschini, Mr. Price, and Truworths are their major competitors. All these retail outlets target the same differentiated market segment of (high, middle and lower) income markets and are able to compete via a pricing strategy, differentiated product offering and improved layout of chain stores by improving and duplicating accessories within stores of their competitors. Therefore, in order to attain a sustainable competitive advantage in this climate, the strategy adopted by Edcon needs to be externally 'invisible' to their competitors.

### **5.3 Gap Analysis at Edcon**

The simplest form of assessing where your organisation's business should lie is in conducting a Gap analysis. According to Billsberry cited in Ambrosini (1998:220), gap analysis is less concerned with the fact that there is a gap between things, than with how to close the gap. Recognition of the fact that a gap exists is only one stage in the process. Having recognised that there is a gap, organisations need to develop strategies that will close the gap, manage the process of change and finally monitor the process to ensure that the same gap does not reappear and, if possible, to open a favourable gap with the competition.

Figure 5.1 depicts a graphical representation of what gap analysis is about. The typical questions that Edcon have asked themselves in the wake of dwindling headline earnings in 1998 were as follows:

- Where are we now?
- Where do we want to get to?
- How do we get there?

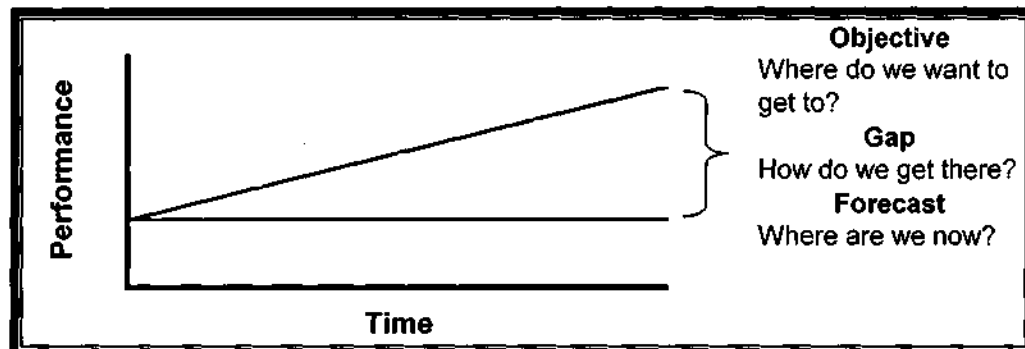


Figure 5.1:- Gap Analysis (Source: Ambrosini, V. 1998. Exploring Techniques of Analysis and Evaluation in Strategic Management. Prentice Hall – New York)

The answers to these questions were quite simple. Using the AD Little portfolio matrix, the management at Edcon were able to determine that Edcon was situated in a tenable position in a mature retail industry. Management was clear that they required Edcon to migrate into a strong position within a mature retail industry. In order to achieve this strong positioning in the retail industry, Edcon adopted a hard ball strategy in identifying the strategic control tool of Asset-Backed Securitisation. By applying the Asset-Backed Securitisation in the form of OntheCards Investments, Edcon was able to separate its credit granting business risks from that of its retail business. The critical success factors for OntheCards Investments were:

- Obtaining favourable ratings for the underlying securities from an international rating agency;
- Produce an asset pool whose cash flow was predictable; and
- Structure OntheCards Investments as closely to the best practices, as advocated by the literature on Asset-Backed Securitisation.



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In applying OntheCards Investments, Edcon have identified the critical success factors and improved their business processes to deliver these critical success factors. In improving their lenient credit granting procedures and their credit operations, Edcon has created a core competence for Edcon. They can now boast that their credit operations are the one distinctive competence that they conduct the best, not only within Edcon but also amongst its competitors.

#### **5.4 Strategy making and implementation Process at Edcon**

Strategic planning is possibly one of the most frequently used terms in organisations. It is also one of the least understood terms. A review of published literature in books, academic journals and the popular press clearly evidences this reality in that many, and varied, definitions are given. This has been reviewed in chapter two, the role and formulation of corporate strategy.

According to Sulcas (2004), internationally acclaimed 'experts' in this field, including Michael Porter, Henry Mintzberg, Kenichi Ohmae, Peter Drucker and others, have failed to produce a standard interpretation. This could be one of the contributory factors concerning the confusion in the mind of many managers.

On one side of the spectrum the process of strategic planning involves a formal top-down 'prescriptive' approach to positioning the organisation for the future. Senior management make the necessary decisions and it is then left to lower level managers and staff to implement these decisions. Large financial and banking institutions would logically follow this route. An alternative 'emergent' approach is advocated by Mintzberg (1998) and others who suggest that strategy should evolve in an organisation. In terms of this, the 'strategic process' is far less formalised, more flexible and driven by the changes in the market place. From a strategic perspective, initiatives are mounted and operationalised based on mutual trust and respect, as well as open and on-going communication among management and the employees. Entrepreneurial enterprises would fit

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into this group in that management and employees jointly make decisions regarding what should be done for the future.

Whatever approach is followed, the prime objective is to improve, or at minimum maintain, the competitive positioning of the organisation. At best, this will lead to improving market share, profitability, and other favourable indices of 'performance'. An additional desired outcome could be the development of scenarios for the future. Whilst not focussing on specific recommendations, these scenarios highlight a number of possible alternatives and what the potential implications could be. It is then up to senior management to choose the most appropriate scenario.

This is typically the strategy making approach that Edcon has adopted in the years since 1998. Edcon have embraced the situational analysis of Porter's Five Forces Model (1980) and used the PEST and SWOT Analyses to identify the factors and forces facing the organisation. Based on these results, Edcon have embraced the resource based theory and implemented OntheCards Investments. The implementation of this strategy was focused and implementation aligned to the manifesto for a hard ball strategy, to create an internal profit centre for Edcon, which other competitors would not be able to easily duplicate without major investment in linking their business processes.

Given the above, I can conclude that Edcon are able to identify the best practices from the many formal strategic frameworks and apply them to Edcon strategy making decisions.

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## **5.5 Benefits of OntheCards Investments**

The benefits have been identified for OntheCards Investments, based on the research:

- By applying OntheCards Investments, Edcon have improved their credit operations according to internationally acceptable standards. This has been achieved by investing in technology and partnering and outsourcing certain functions with companies and consultants that have industry knowledge, like Fair Isaac and Accenture SA.
- By improving the credit operations, Edcon have developed a core competence in their credit operations that have secured the success of OntheCards Investments.
- The implementation of OntheCards Investments has demonstrated to the retail industry that there are strategic controls tools outside the retail industry that can be 'plagiarised' and applied to the retail industry.
- OntheCards Investments have changed Edcon's strategic control process from the traditional approach which is a feedback process to one of a focused alignment approach, which advocates aligning controls within Edcon. This model is a proactive model which ensures management measure performance that would lead to competitive advantage.

## **5.6 Conclusion**

Five years ago, Edcon's headline earnings plunged to a record low of 148 cents per share (1998). Edcon were also accused of ineffectual leadership and management and an appalling credit policy. The management of Edcon was quick to ascribe ill fortune to forces beyond their control, yet some poor decisions had contributed greatly to the organisation's precarious situation. There was a lack of communication between people, no effective performance management system and general feeling of disheartenment.

In 2004, Edcon has achieved their highest headline earnings of 1,597 cents per share and a share price of R124 compared to 1998 of R15. So how has the turnaround been achieved? Today, there is a culture of hope which recognises and encourages exceptional individual performances. People who were once

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stifled are now recognised and occupy responsible positions. These changes are aptly captured by Hamel and Prahalad (1989:64) cited in Mintzberg et al (1998), strategy intent envisions a desired leadership position and establishes the criteria that organisations will use to chart its progress. The concept also encompasses an active management process that includes focusing the organisations attention on the essence of winning; motivating people by communicating the value of the target; leaving room for individual and team contributions; sustaining enthusiasm by providing new operational definitions as circumstances change and using intent to consistently guide resource allocations. Senior management at Edcon firmly believe that it is about making good people choices over and over again. This is enabled when management show interest in staff satisfaction rate and communicate honestly with staff.

Edcon's success is generally about a wide range of processes that have been implemented. One of the key processes that have been improved is the credit operations of Edcon's business. Another task that Edcon management wanted to address was to successfully separate their credit granting business from retail operations. Asset-Backed Securitisation was the vehicle identified and used in the form of OntheCards Investments. According to Hamel and Prahalad cited in Mintzberg et al (1998) stretch is defined 'a misfit between an organisations resources and its aspirations.' Some organisations have ample resources but lack aspirations, on the other hand there are organisations that are driven by high aspiration but have meagre resource bases. Hamel and Prahalad propose that leveraging a limited resource base can be done in various ways; by concentrating resources more effectively around a strategic focal point, by accumulating resources efficiently, complementing one resource with another, conserving resources wherever possible and recovering resources from the marketplace in the shortest possible time. These writings are reflective of Edcon. In identifying a strategic focal point, Edcon identified the packaging of their receivables into an Asset-Backed Securitisation and using it as a strategic control tool that would separate its credit granting business from its core business of selling textiles, shoes and accessories in the retail industry. The Asset-Backed Securitisation was a classic example of Edcon having high aspirations and effectively addressing their aspirations by

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identifying and mobilising the correct resources. This was accomplished by Edcon understanding that there was duplication of core functions like credit management which was not centralised between the business units. Management embarked on investment in information technology and credit management systems that were pivotal in making OntheCards Investments a success.

OntheCards Investments was a revolutionary strategy that ignored conventional industry strategies in the retail industry. I can therefore, conclude that Edcon's management has been able to articulate soundly what their strategy is and implement this strategy successfully. This is based upon the fact that they have adopted a hardball strategy in Asset-Backed Securitisation and went about implementing it with determination and focus that has seen OntheCards Investments become a success.

Strategic control within Edcon has largely been a traditional approach in the year's preceding 1998. This traditional approach involved taking corrective action as a final intervention. This traditional approach was often a responsive action. With the application of OntheCards Investments, the strategic control process will be focussed on an alignment approach, which will allow management at Edcon to adopt a feed forward approach and align with the critical success factors of Edcon. In their case, the credit management is integral to the continued success of OntheCards Investments. Therefore, Asset-Backed Securitisation is an effective strategic control tool that will assist Edcon to focus on *marketing and selling of their product in the retail industry* and not worry about managing the credit risk of their account holders.

The credit operations of pre 1998 would certainly not have held up to the requirements of the Asset-Backed Securitisation. The fact that the changes were made to such a revolutionary degree, demonstrates that the management are serious about making the business the best it could be. The new improved credit operations are robust to make the strategic control tool successful. This robust credit operation is further given a vote of confidence in Moody's improving the credit rating of the Class B notes in OntheCards Investments.

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In conclusion, Edcon has been able to adapt and apply the onerous and rigorous Asset-Backed Securitisation process in OntheCards Investments to achieve their Strategic and Financial objectives.

## **5.7 Recommendations**

My recommendation to Edcon would be to use their leveraging capabilities and take on more debt. This is possible as their current leverage is only 6% and management have set a target of 25%. The recommendation is made because debt is lower cost of financing and the tax shield provided by the interest payment will allow Edcon to improve on their bottom line earnings. With greater leveraging, and improved cash flow, Edcon would have access to more capital for research and development and investment.

A recommendation for future study will be to assess the opportunities around the American Depositary Receipt Programme that Edcon has initiated in June 2004 and assess the impact that this ADR programme will have on Edcon. There could be value in this study, given the fact that there are already 42 other South African companies that embarked on this ADR programme.

Another recommended area of study will be to determine how willing are commercial banks to actively promote Asset-Backed Securitisation within the retail industry. Should commercial banks developed generic Asset-Securitisation structures and market them to retail organisations?

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